EDITORIAL

The Threat of Inflation of the Currency

As this issue of The Journal of Accountancy goes to press there is still a lingering hope that some method may be devised by the administration or by congress to avert the threat of uncontrolled inflation of the currency. As every one should know we are already suffering from inflation, and the outlook is far from cheering. The best we can do is to pray that the danger may be turned aside; but in the meantime it becomes necessary in the cause of prudence for every man engaged in business or finance to take thought for the morrow, in case that morrow bring "greenback" currency or any other unsupported issuance of legal tender. Men are asking themselves: What shall we do if the country is to fall into the pit of inflation? How shall we protect our assets against total loss? Can we protect them? The experiences of European nations in the last one hundred and fifty years have been identical in this, that no such thing as controlled inflation is possible. Once a country departs from some standard, whether of gold or silver or any other, it goes further and further, increasing its speed in geometrical progression until at last comes utter debasement. Is there any way still open to the owners of capital to prevent the entire loss of their holdings through the prostitution of the dollar? Various plans have been described in print and the experience of the people in Germany, Austria, France and elsewhere has been called upon for an index to some measure of protection. It has been said that the value of bonds and all income-bearing certificates of indebtedness will become infinitesimally

161
small, whereas common stocks of companies which will be able to pay increased dividends in paper money will advance. It has been said that the best measure of safety is to purchase fixed commodities not subject to quick deterioration—such things as land, iron, cotton and the like. The theory is that one who buys these things at present prices may hold them through the debacle, and, when some fixed currency shall have been established after the disaster, they will have a value computed in terms of such succeeding currency, or they may be sold during a time of exorbitant prices and the proceeds may be invested in articles of permanent value at that time. The truth seems to be that the only beneficiary of uncontrolled inflation might possibly be such institutions as insurance companies and other fiduciaries which are required to pay out certain amounts in dollars (although here, again, inflation would cut both ways). If those dollars become as cheap as they may be the drain upon the payer will be insignificant, and in the meanwhile his capital assets will be rated at a number of dollars altogether out of proportion to their intrinsic value in gold. At present there is a nominal relation between gold and currency, but once the printing presses start the relation will be severed. This is a problem of the utmost direct interest. No one knows the answer, but the opinions of those men who are best qualified to speak will be welcome. The country needs their advice lest the storm break upon us and catch us unaware.

After the foregoing comments had been written the daily papers published a striking commentary on the same subject. Our former president, Herbert Hoover, testifying in the superior court of San José, said that the possible menace of currency inflation threatens the equity of endowed colleges which have the bulk of their funds in securities payable in fixed amounts of dollars. The case in which this evidence was given was based upon a petition that the trustees of Leland Stanford university be permitted to invest trust funds of the university in stocks of well managed corporations because it is no longer possible to obtain adequate interest from real-estate loans, from investment bonds and other securities.

The Apportionment of Fame

Certain comments which appeared in THE JOURNAL OF ACCOUNTANCY for February have led to a good deal of correspondence and various opinions relative to the incidence of
fame and fortune have been proffered. The notes to which we refer were based upon allegations which had been made by a correspondent to the effect that some accountants achieve a prominence which is denied to other men of equal ability. If we may judge from the letters which have reached us there seems to be general agreement that any accountant can make opportunities for himself. But this is only partly true. There is a degree of luck or destiny which comes to some men and not to others. In the large, however, it is certainly true that most of the people who complain because they do not arrive among the eminent can attribute their failure to their own lack of initiative. Men who share the sentiments of discontent make the not uncommon error of looking at results only and ignoring what lies behind them. The most genuine ground of complaint is that some men are given opportunities for service to the public and the profession which are denied to others. We must assume—and observation and experience confirm this—that the men in the profession who are most active in public and professional life are actuated by a desire to serve the public and their fellow practitioners. Of course, there have been instances of publicity seekers who have tried to use their professional prominence for their own advantage, but, generally speaking, these pushing people have been fairly well understood by their colleagues and have not really been as great as they thought they were. If any man, great or small, offers to serve for his own advancement or to increase his own prominence he is a hypocrite, and it would be difficult to speak too harshly of him; but if a man have an earnest desire to contribute to the advancement of his profession and of his community he can complain only if he is denied opportunities for employing his abilities for the common good.

Avenues to Success One of the first openings to the accountant is service to his local society. State society presidents do not as a rule complain that they are embarrassed by excessive numbers of able men clamoring to devote their abilities to society work. The usual complaint is that it is difficult to find enough men who will give their time to such activities. Probably every state society is seeking for new blood to revivify somnolent or moribund committees. Many societies of credit men, cost accountants, engineers and others whose work is allied to accountancy welcome public accountants as members and
generally like to have them serve on appropriate committees where their knowledge will be of great use. Similarly hospitals and all sorts of eleemosynary institutions are glad to have accountants among their workers. Indeed, opportunities for service are wide and unrestricted. The pity is, not that a few men become well known, but that more accountants do not give their time and ability to these things. It is true that some men will be called upon for more responsibility and more conspicuous service than others, but there is no doubt that any accountant who is sincerely anxious to assist will find work suited to his capacity. He deserves no less and can ask no more. But it must always be remembered that this type of service involves long, hard and sometimes wearisome apprenticeship and sacrifices of time, money and other interests, and often it must be carried out in the face of stupid opposition and allegations of self-seeking. Most men who are now prominent have gone through the apprenticeship, have made the efforts and sacrifices and have generally found that their principal reward was a sense of duty well done and that the material benefits of such prominence were difficult to discover or appraise. As we have said many times, writing on professional subjects is open to every man of education and experience. The total volume of technical literature is not large. Indeed, the amount that is outstanding or even good enough to be put in type is regrettably small. We wish that every accountant who knows something about his professional work which has not been adequately described in the written word would feel an obligation to write for the benefit of his fellows. The unwritten books which the profession needs are almost innumerable.

**Success Not Dependent on One Factor**

No accountant can honestly complain of the prominence which others achieve by professional and public services until he has made the attempt and made the sacrifices which are required to take advantage of the opportunities offered him in his own group or community. The man who does not support actively his local society, his national organization and the progress of his community is in no position to carp at the success of those who do these things. The men best known in the profession, who act from a desire to benefit the profession as a whole, generally accomplish something well worth while. Favorable publicity for any accountant may bring direct results to the whole profession.
Editorial

An accountant in an important public capacity in a great city raises the standing of the practitioner in a small town. It is not true, as some people seem to believe, that an extensive and lucrative practice can be built up only by obtaining outstanding and conspicuous position in local and national organizations. There are many firms which have achieved great success without any special attention to the activities of professional societies. But, after all, is not the question whether a man be seen of all men or honored by them of secondary importance? Success may be great and everlastingly gratifying whether it attract much attention or not, and any man succeeds who does his work honestly and well. The present high standing of accountancy is chiefly attributable to the labors of men who did not stop to consider whether they or some other men were the more thunderous in the index.

Proper Treatment of Delayed Items

We have received a letter from W. D. Shay, a member of the American Institute of Accountants, taking exception to our editorial comments in the December issue and incidentally drawing attention to the obvious typographical error in the next to the last line of page 401 where the word “pre-depreciation” should read “pre-depression.” Mr. Shay’s letter deals at length with the much debated question of the proper treatment of delayed items, and he says: “The main point I wish to make is that charging such retirement losses to railway operating expenses would not be proper accounting. The retirement loss is nothing more or less than the result of the carrier’s failure to make adequate provision for the depreciation of these particular units of equipment in prior years, including the blight of obsolescence which has fallen with severity upon railroad equipment. Possibly a negligible amount might be considered to apply to the current year, but here again I think we may assume that very little, if any, of this equipment had been used for transportation purposes within the particular year of its retirement.” There is much to be said in support of the view which Mr. Shay advances, but it does not seem to us to be relevant to the particular question discussed in the editorial. It is a subject on which a great deal could be written, but it was beyond the purpose of our editorial to enter into any such discussion. When the commission says that it has allowed items to be charged to one account instead of another, it clearly implies that the other account is the one to
which the item should normally be charged. If the repairs referred to in the passage of the I.C.C. report, which we quoted, are properly chargeable to profit-and-loss, then it is meaningless, if not misleading, for the commission to say that they "have been, with our permission, in part charged to profit-and-loss instead of to operating expenses."

Value of Loose-Leaf Records

A correspondent, discussing the decision in a British court that loose-leaf records were not books in the meaning of the English companies acts, which was the subject of comment in the December issue of The Journal of Accountancy, expresses the opinion that there is a good deal of justification for the decision rendered by the judge who tried the case. His point is that, while manipulation may be rare, it is more easily effected in the case of loose-leaf books than in books permanently bound. No one has denied the truth of this contention, but what we attempted to say in our comment was that a practice which had been adopted throughout the civilized world could not easily be abandoned and, furthermore, that manipulation was not impossible whatever kind of binding might be adopted. The most interesting part of our correspondent's letter reads as follows: "It is true as you say that bound books can be manipulated, though it would require some degree of artistry to make an undetectible substitution. This is effectively prevented in many of the Spanish American countries where I have practised. There, every book to be of subsequent value as evidence in any dispute must first be submitted to the 'juzgado', where every page is stamped with the seal of the court and the certificate is written on the first page thereof, stamped and signed by the judge, stating the exact number of pages and numbered from, say, six to sixty, and authorizing its use for the purpose indicated. In all my residence in those countries I never heard of a manipulation of a sheet of a book so treated." There can be no doubt that such a system of identification would probably prevent an alteration in the contents of a book, but the same precaution if observed in the case of a loose-leaf volume would be equally effective. There are, of course, obvious obstacles to such a plan in a commercial country as large as the United States or Great Britain. The mere time and labor involved in the certification of each page of the financial records would be prohibitive.

166
Our Incomparable Ability to Forget

It is perhaps inevitable that in a comparatively new country the inhabitants should be blessed or cursed with short memories. The progress of such a country is so rapid that there is a tendency to think almost exclusively of the present and the future and to dismiss the past as something of no further interest. The United States of America, of all the great nations of the world, is the youngest. Its material success is almost unparalleled in history. Therefore it is not entirely astonishing that American people should have an unfortunate forgetfulness of the important things of even the most recent past. As an illustration, it is impressive and somewhat discouraging to witness the reaction of a great percentage of the population to the materialization of things the fear of which only a few years ago perturbed us all. Since the first of the new year tremendously significant events have happened. The soldiers' bonus has become law, and a few more billions—no one yet seems to know how many—are added to our already unprecedented national debt. For several years past people have been dreading the enactment of such legislation, which was regarded as a categorical imperative to start the printing presses which would turn out baseless and unlimited quantities of paper currency. Again for years past there has been at first a hesitant and then a stern demand for an honest attempt to balance the national budget. The gai nonchalance with which the country has become spend-thrift far beyond the country's means and the apparent indifference with which increasing deficits have been regarded have caused grave misgivings among the intelligent part of the people, and it has been freely predicted that the nation before long will lose its credit and wreck its future. Yet scarcely a day passes without some unpremeditated appropriation of funds which do not exist and must be derived from heaven knows where. A balanced budget is mentioned occasionally in the councils of the temporarily mighty, but it is rather as a sort of academic and remote possibility than as a vitally necessary condition to prosperity. As the American reads his morning paper and learns of fresh inroads upon the capital structure of the country he gasps, if he be an ordinary middle-of-the-road man he swears a little and then straightway forgetteth what manner of fear it was which afflicted him yesterday. It is all part of our national capacity for forgetting. That it is unwholesome and mortally dangerous we know, in our rare moments of calm contemplation,
but we do nothing much about it and have an innate feeling of confidence that in spite of all the perils that surround us we shall yet emerge victorious and happy. But it is possible to indulge in unreasonable optimism. America does not differ in essential things from any other nation, and history does not reveal a single case of a country which went blindly forward into suicidal waste of its resources without exemplifying that axiom of physics that to every action there is an equal and opposite reaction. One can hardly throw away his heritage without becoming a pauper. Divine Providence has blessed America with a richness almost unique, but even the most gigantic power and the most widespread prosperity can not stand against a determination of the people to squander their wealth and to debauch their strength.

**Blind Faith in Our Stars**

There is a ray of hope coming over the horizon, and we still believe that there will be a sufficient protest and a sufficient demand for reform to bring about a change of course before the rocks are reached. It has been said often that the common sense of the American people always reasserts itself most emphatically when it seems to have been lulled into silence. Financially we have abandoned for a while many of the fundamental principles which have made us a great nation. We have indicated that we do not care whether we can pay our way or not. We have listened to the allegations that emergency demanded extraordinary acts, but now even the most patient American is becoming weary and a little fretful, and finally he will assert himself and insist that we shall be as honest with ourselves and with the rest of the world as each individual member of the public would be in his own personal relations with his fellow men. The wild and thoughtless spending still goes on, and perhaps will continue for a few more months, but there will be an end—unless America is America no more and unless we allow our fatal forgetfulness of facts to destroy us.

**A Wall Motto Suggested**

The point which we are trying to make in these notes is that the American people should remember the recent course of events and should not allow anything whatever to dim their vision of facts. It would be a very good plan for every business man, every housewife, every taxpayer and, above all, every
Editorial

politician to hang in some conspicuous place, where he could see it hourly, a condensed tabulation of things that have been done. For example, he might set down upon this chart of history statistics of the national debt, leaving space to add from day to day the increases which occur. He might set down also a record of the promises of politicians. That would be a long list. Opposite he might leave space for promises fulfilled. The keeping of that record might be tragic but it would not make heavy demands upon one's time. He might summarize attempts made ostensibly to encourage business, agriculture and other industry; and on the opposite side he might show in a few words the effect of each attempt. He might include a statement of what he and his business associates think should be done to stimulate business of all sorts. And there are many other things which might be included in such a chart of fact. It is a fixed law of golf that he who would play the game must keep his eye upon the ball and not be distracted by the conversation around him nor by the dance orchestra on the club-house veranda. A prominent accountant used this metaphor the other day to drive home the argument that the salvation of America rests in the ability and determination of the people to remember the important things. Accountants in their relation with clients and other men are constantly confronted by the national characteristic of forgetfulness which we have been discussing. It is the function of the accountant to remember, and consequently he must be impressed by the failure of many men who should know better to keep the truth in mind. If the great majority of the people will hold fast to the faith of their fathers and will let their voices be heard in unison, insisting upon the adoption of the basic principles of honest business applied as they should be to national affairs, all will yet be well. If they fail to do so the end is not far off. We have lived in a sort of riot of doubt and uncertainty. We have talked so much about depression and emergency and unemployment that we have become almost addicted to panic fear, and we begin to enjoy bad health. In our hearts, however, we feel that all the outcry and the wailing are unnecessary. The conditions have been bad and are still bad enough, but we need not howl so much. If we will remember what was and what is and what might be—easily might be—we shall learn the truth—and we have it on ultimate authority that the truth shall make us free. Perhaps it is not an exaggeration to say that the greatest need of America today is memory, and
the next greatest is the exercise of common sense. Even the political potentates can hear and heed.

"The Influence of Accounting on the Development of an Economy"

In this issue of *The Journal of Accountancy* appears the last of a series of three articles by George O. May, under the general heading, "The influence of accounting on the development of an economy." These articles seem to us of such importance that we have requested the consent of the author to reprint them in pamphlet form. Mr. May has agreed to this proposal on the understanding that the price of the pamphlets is to be kept close to cost of publication and that any profit be devoted to educational purposes. The articles, which can be read most profitably in conjunction with correspondence between the New York stock exchange and the American Institute of Accountants (already published in pamphlet form by the Institute) reflect the results of thinking on accounting questions by a man who has been for twenty-five years the head of a leading firm of accountants. His interest in the Institute has been particularly in the educational part of its work. The series of articles which we shall publish in a pamphlet will, we believe, be of more than transitory interest to the whole profession.
The Influence of Accounting on the Development of an Economy

By George O. May

III. Railroad Retirements and Depreciation

In this article I propose to consider briefly some economic and historical aspects of the problem of accounting for the exhaustion of the useful life of fixed properties (not including equipment) of railroads.

I have chosen this question for discussion for a number of reasons. Undoubtedly, the way in which it has been dealt with has had a marked effect on the economic development of our country; it lies in the field in which, as I pointed out in my first article, the most important problems arise which the accountant has to consider; it has a close relation to the question of regulation of rates on the basis of capital values on which I touched in my second article; and the Interstate Commerce Commission has, in recent years, decreed a revolutionary change in the practice of carriers under its control. An examination of past practice and of suggested alternatives raises sharply the question of the nature of accounting conventions and of the justification therefor.

Methods of providing for the expense represented by the exhaustion of property, though varying greatly in detail, fall into two broad classifications: those which aim to distribute the charge as uniformly as possible over the period of usefulness of the particular unit of property, and those according to which the time for making the charge is fixed by the actual or impending retirement of a unit. The former are commonly referred to as depreciation methods and the latter as retirement methods, and these convenient designations will be employed in this article.

In order to keep the discussion within appropriate limits, it seems desirable to restrict it narrowly to the fixed properties of railroads and to refrain from dealing either with equipment, which constitutes the other main division of the capital assets of railroads, or with the case of other public utilities. The cases of fixed property and equipment differ in the fundamental fact that so long as operations are continued, fixed property must either be reasonably maintained or replaced, while so long as an adequate supply of newer equipment is available to do the work of the road,
obsolete equipment can be kept in nominal service and under a retirement system of accounting carried at cost in the accounts, indefinitely. It was doubtless this consideration which led the Interstate Commerce Commission to require the railroads in 1907 to adopt a system of depreciation charges in respect of equipment, but not in respect of track and other fixed properties.

Up to the present, railroads both here and abroad have generally adopted retirement methods. The question whether railroads should adopt some depreciation method does not appear to have been extensively considered in our country at least until the railroad system was largely built up. The word "depreciation" does not appear in the Instructions in regard to the keeping of Railway Accounts, issued by the Railroad Commissioners of Massachusetts in 1876, or in the index of Hadley's *Railroad Transportation* (1885), or in the decision of the Supreme Court in *Smyth v. Ames* (1898). Our practice, however, was undoubtedly greatly influenced by English practice, and in that country the issue was hotly discussed as early as the middle of the last century, following the collapse of the great railroad boom of the forties. A select committee of the House of Lords in 1849 took testimony on the subject (including, incidentally, that of an accountant who stated that he had been carrying on his profession in London for more than twenty years) and in its report favored the creation of depreciation reserves:

"It must be obvious," it said, "that for the maintenance of railways in a due state of efficiency, as relating to the way, the buildings, the rolling stock and other property, an adequate provision ought to be made, as a matter of necessary precaution and prudence. The creation of a Reserve or Depreciation Fund for such purposes, as contemplated by Parliament (Companies Clauses Act of 1845, 8 Vict. c.16, s.122)*, seems now to be generally admitted as necessary, and in some instances, the Committee rejoice to observe, it is practically adopted. Without such fund there is a constant temptation to misapply capital, where capital still exists; and where capital is exhausted, the progressive deterioration of the line can hardly be avoided, greatly to the risk of the public, and to the inevitable sacrifice of the ultimate interests of the company itself. It would be difficult to prescribe by law the exact amount to be carried annually to this fund; but the

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* The provision seems to have been permissive rather than mandatory. Section 122, the section cited, provides that:
"Before apportioning the profits to be divided among the shareholders the directors may, if they think best, set aside thereout such sum as they may think proper to meet contingencies, or for enlarging, repairing, or improving the works connected with the undertaking, or any part thereof, and may divide the balance only among the shareholders."

172
fact of the creation or the non-existence of a Reserve or Depreciation Fund, together with its amount, where it exists, should always appear upon the face of the accounts. The receipts and expenditure of such fund, where it has been established, should in all cases be kept and exhibited, separate and distinct, should be examined and certified by the auditors, and should be annually submitted, as well as left open to the inspection of the shareholders."†

The controversy continued for many years until the passage of the Regulation of Railways Act of 1868. That act provided a special form of accounting for railways, which came to be known as the double account system. Under that system, all capital outlays were carried in an account entitled "Receipts and expenditures on account of capital"; only the balance of this account appeared in the general balance-sheet of the company. Rejecting the pleas that depreciation reserves should be made mandatory, Parliament contented itself with requiring certificates that the properties had been adequately maintained and that the dividends proposed to be declared were, in the opinion of the auditors, properly payable after making all charges against revenue which in their opinion ought to be made thereagainst.

Thus, while directors were free to make provisions for depreciation if they saw fit to do so, the question whether such provisions had to be made turned ultimately on whether the auditors regarded such depreciation as one of the expenses which ought to be provided out of revenue; and leading accountants both here and in England took the view that this was not a necessary expense.‡

I turn now to consider what the effect on the development of our country would have been if the depreciation method of accounting had been put into effect in the early days of railroad enterprise. I raised this question in a memorandum which was submitted to the Interstate Commerce Commission and in an article which appeared in the Quarterly Journal of Economics of February, 1929, and from which I may, perhaps, quote:

"The result of a depreciation plan is obviously to throw an added charge for use and exhaustion of property upon the earliest years of operation, years in which the traffic development would be in progress and in which consequently the charge would be more burdensome than in later years. Such a condition would seem to be exactly the reverse of that which would be economically desirable from the standpoint of the community. Its interests

‡ Cf. H. R. Hatfield, Accounting, p. 142.
would be served by keeping the charges in the early years down to the minimum consistent with maintaining the efficiency of the property, thus enlarging the volume of the commodities that could profitably be transported, and building up both the traffic and the community more rapidly than would otherwise be possible. The best interests of the community in such a situation would be served, it would seem, by a mutual agreement to ignore the depreciation on the property in so far as it could never be made good while the property was being operated; the owners of the railroad agreeing that this depreciation should not be treated as a part of cost of operation, and the community agreeing on the other hand that in computing return no deduction should be made from the original investment therefor.”*

From a financial standpoint, with depreciation charges treated as a part of operating cost, only a small proportion of the enterprises proposed could have been claimed to present the prospect of being able to earn their fixed charges within a reasonable period after being opened for traffic. The published results of the ventures of those who had been bold enough to proceed would have discouraged others from attempting similar enterprises. On the basis of the accounting methods then employed, which ignored accruing depreciation, Hadley estimated in 1885 that the railroads as a whole were earning not more than five per cent on the actual capital invested. To my mind, it is incontestable that the effect of the application of such depreciation accounting would have been that the construction of a large part of our railway mileage would at least have been greatly delayed—if, indeed, some part would ever have been constructed at all. Such a result would have been exactly the opposite of that sought at the time by legislatures and the public.

Hadley begins his chapter on railroad legislation with the statement:

"The early railroad legislation in the United States was devised for the object of securing railroad construction. The only fear was that railroads would not be built as fast as they were needed.”†

And as late as 1907 the Interstate Commerce Commission was complaining

"It may conservatively be stated that the inadequacy of transportation facilities is little less than alarming.”‡

Since the development of other public utilities and commercial

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*Vol. XLIII, p. 211.
enterprises followed naturally on the development of railroads, this portion of the growth of our capital equipment would also have been greatly retarded. It has been said that we owe our great railroad facilities and the developments which they made possible, in a large measure, to unsound finance; but if it be held that depreciation provisions are an essential element of sound railroad accounting, then unsound accounting must share with unsound finance in the responsibility for the tremendous economic development that has taken place since railroad enterprises were first begun. I do not here undertake to consider whether the growth may have been too rapid to be healthy—I make only the point that the accounting practice affected the economic development of the country—whether for better or for worse, others may dispute.

It is no doubt true that as a result of the accounting methods followed, large amounts of capital have been lost by investors. How large such losses in the aggregate must have been is brought home to us when we consider enterprises such as street railways, in respect of which capital has been furnished by investors—first, for the cost of an original installation of horse-cars, and then for the cost of equipping the lines for electrical operation (with, in some cases, an intermediate cable development); and, finally, as we have recently seen in New York and elsewhere, the electrically operated street-cars have been displaced by buses. This, however, merely emphasizes the truth too often ignored by unfriendly critics of the existing economic order—who see only the large gains made by a relatively small number of fortunate individuals from the development of the capital equipment of the nation—that in the aggregate, the community pays only a relatively small return to capital for the amount invested, and that it is the community that is the one sure gainer therefrom. However legitimate the project, however honest the finance, however conservative and scrupulous the accounting, and however competent the management may be, the losses in industry are bound to be enormous, and the community can well afford to allow the few who meet with unusual success to receive and retain substantial rewards as a part of the price it pays for all the capital invested.*

I should perhaps anticipate here an objection that the methods of accounting adopted may have been an effect rather than a cause: the objection that this may be a case in which methods of

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* Failure to recognize frankly these simple truths seems to me to be a major ground for criticism of measures for control of security issues which have been put forward in the last year or two.
accounting have been influenced by other than accounting considerations, rather than one in which accounting judgment has influenced the economic development. True, the methods followed here and in Great Britain might represent the giving of effect to an opinion deliberately reached as to what was economically desirable, or they might be the reflection of the views (born, perhaps, of the wishes) of those who were interested in the creation of such enterprises. There is, however, nothing to suggest that the depreciation method was regarded by those responsible for the enabling legislation, either here or in England, as sounder but was deliberately ignored because it was believed that the development and welfare of the country would be aided by ignoring it. Nor do I believe that those who were responsible for finding the capital for railroad enterprises in England or here, or those auditors in England who were required under the Act of 1868 to certify that dividends were bona fide due after providing for the charges which ought to be made against revenue, believed that sound finance or good accounting called for depreciation provisions which would ultimately provide for the amortization of outlays on all property except that which was indestructible and could never become obsolete, and deliberately refrained from requiring such provisions.

The policy that omitted any provisions for depreciation was, in England, entirely consistent with the policy which omitted any provision for amortization of obviously wasting assets such as mines, ships, or annuities. It was consistent with the whole theory of the determination of income under the English income-tax laws (which had been revived in 1842 before railroad development in England had proceeded very far). American practice in the early days was undoubtedly determined largely by English precedents, which was natural in view of the fact that the capital for our railroad enterprises came largely from abroad, and particularly from England.

I believe that in dealing, or omitting to deal, with depreciation the railroads merely followed the general accounting practice of the times. In my first article, I referred to the change of attitude on the question on the part of the Supreme Court between 1878 and 1909.* It was not until the present century that depreciation charges became general even in industrial accounting practice in our country—in fact, full recognition of the necessity therefor

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might almost be said to date from the enactment of the first corporation income-tax law in 1909, under which depreciation was an allowable deduction which corporations generally were anxious to secure, and which was allowed only if taken up on the books.

The first serious proposal to apply depreciation methods to fixed properties of railroads appears to have been made as the result of the study of the question of railroad valuation by the Interstate Commerce Commission under the Valuation Act of 1913 though, as already noted, the Commission had in 1907 taken steps looking to the application of a depreciation method to railroad equipment. In its valuations under the authority of the Act, the Commission consistently deducted from the gross value depreciation on what is known as the straight-line method—that is to say, the method which aims to distribute the ultimate loss of value evenly over the service life of a unit of property. The Supreme Court in its decisions on valuation questions has consistently rejected the straight-line method, and the deductions it has recognized have resembled more nearly what has been called observed depreciation.

By an amendment to the Interstate Commerce Act in 1920 (Section 20, §5), the Interstate Commerce Commission was given authority to prescribe the classes of property for which depreciation charges might properly be included under operating expenses and the percentages of depreciation which should be charged with respect to the uses of such classes of property. After much consideration of the question and extended hearings, the Commission handed down a report in November, 1926*; but as a result of objections to its conclusions, granted a rehearing which eventually resulted in a new report dated July 28, 1931.† This varied in some important respects from the earlier one, but adhered to the theory of straight-line depreciation which the railroads were ordered to put out of force as from July 1, 1933. The effective date has since been changed by executive order and now stands indefinitely postponed.

Shortly before the second report, the Supreme Court in the United Railways case ‡ had laid down the principle that for the purposes of rate cases any depreciation charge must be based upon

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* No. 14700, Depreciation Charges of Telephone Companies; No. 15100, Depreciation Charges of Steam Railroad Companies.
† Same title.
present value and not upon original cost, as was contemplated by the Commission. Clearly, however, a system of depreciation charges based upon a fluctuating present value was altogether impracticable for the purposes of current accounting by the railroads. If the Commission was for such current purposes to require depreciation charges, they could hardly be based on anything except cost. At the same time, with the Commission insisting on straight-line depreciation and original cost, and the Court insisting on observed depreciation and present value, there was no apparent prospect of the Commission attaining the objective which it had stressed of placing railroad accounts on such a basis as to make them equally useful for the purposes of current accounting and rate-case determination.

In the report of 1931 the Commission, after citing the varied views of carriers and the need for uniformity, concluded that a depreciation method was preferable to a retirement method. Observing that in regulating accounts the Commission was performing its administrative function, and that so long as the regulation was not arbitrary in the sense of being without reasonable basis, there was no ground for judicial interference, it proceeded to consider various depreciation methods. It recognized that the arguments in favor of the sinking fund and annuity methods had force, going so far as to say, "It may be that from a scientific and theoretical standpoint the annuity method is the soundest of all," but concluded that the balance of the argument was in favor of the straight-line method. Its discussion of this question concludes thus:

"We are disposed to abide by the finding in our prior report in favor of the straight-line method. It is the method which has consistently been used in our valuation proceedings. On the record before us, indeed, we would hardly be justified in reaching any other conclusion.

"This conclusion, it should also be said, is associated with the confidence we entertain that the courts, when the issues and facts are made entirely clear to them, will recognize the connection and inter-relation between depreciation in accounting and in valuation which have been pointed out hereinbefore" (p. 413).

Here we have what are at once the weakest and the determining arguments of the Commission on the question at issue. While straight-line depreciation unquestionably is commonly used for current accounting purposes, particularly in the industrial field,
its use for valuation purposes does not find support either in theory, in practice, or in court decisions. The Commission's own view of fixed property is that it represents a given number of years of service value. If this view be accepted, the unit which has at the beginning of a year 100 years of useful life, has at the end thereof 99 years of such life left in it, and the reduction in value during the year is measured by the difference between the value of an annuity for 100 years and that of an annuity for 99 years. This difference is not 1%, but less than 1% of 1%.

Continuing, the Commission found that (to use the language of the syllabus), "Depreciation accounting becomes a necessary measure of self-protection to the carriers, in view of the decisions of the Supreme Court of the United States to the effect that accrued depreciation must be taken into consideration in ascertaining the rate-base value" (§ 34, p. 353). This argument would be more convincing if the views of the Commission had been shared generally by the carriers, which, however, regarded the Commission's proposals as "neither practicable nor wise" (p. 382) or if the methods of computing depreciation prescribed by the Commission had been more in harmony with the past decisions of the Supreme Court. Perhaps a more accurate statement of the argument would be that depreciation accounting will become necessary for the self-protection of the carriers if the Supreme Court justifies the confidence of the Commission, recognizes the connection and inter-relation between valuation and depreciation accounting, and does so in such a way as to substitute the Commission's ideas upon depreciation for those which it has heretofore expressed.

Referring again to the syllabus, while paragraph 22 reads: "It is not essential that the accounts should correspond in all respects with the facts which may be controlling in a confiscation case," we find in paragraph 43 the statement: "It is a matter of vital importance to harmonize the requirements for valuation and depreciation accounting purposes, so that unnecessary duplication of effort will be avoided."

Reading the order as a whole, one is left with a very definite impression that the Commissioners participating in it are thoroughly convinced that straight-line depreciation should be deducted from gross value in any determination of the rate base, and that depreciation computed on the same basis should be charged
against income. In order to secure recognition for the first of these two points, they are willing to make large concessions on secondary questions.

Encouraged by dicta in minority opinions of the Court, they hope by the exercise of their authority in the matter of current accounts to induce the Supreme Court at long last to come around to their point of view. In presenting their case they make effective use of the arguments and practices of the telephone companies in support of straight-line depreciation as an operating charge, though declining to accept the contention of those companies that unexpended depreciation reserves are in the nature of surplus.*

In 1934 an opportunity was afforded to judge how far the reasoning of the Commission had made progress with the Supreme Court. The opportunity did not come in a railroad case, in which the proponents of straight-line depreciation would have had to face the argument that their proposal ran counter to the practice of railroads generally, here and abroad since the earliest days of operation, including nearly a quarter of a century during which railroad accounting had been under the jurisdiction of the Interstate Commerce Commission—it came up in the case of a telephone company † which had followed a straight-line depreciation plan after the Commission's own heart. As a result, the depreciation reserve had grown to be from 26% to 28% of the cost of property, including land. The court below had found the proper deduction for depreciation for valuation purposes to be from 15% to 16%, and the telephone company had claimed the proper deduction for this purpose to be from 8% to 9%.

The Supreme Court's decision against the telephone company was based on the ground that it had failed to sustain the burden of showing that the amounts charged to operating expenses for depreciation had not been excessive. It spoke of the "striking contrast" between the reserve that had been accumulated and the existing depreciation as indicated by "proof which the Company strongly emphasizes as complete and indisputable in its sharp criticism of the amount of accrued depreciation found by the District Court in valuing the property."

Mr. Justice Butler, in a concurring opinion, indicated that he was not a convert to the view of the Interstate Commerce Com-

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mission. In doing so, he stated in clear language one of the objections which has been most strongly urged against the depreciation method:

"From the foregoing it justly may be inferred that charges made according to the principle followed by the company create reserves much in excess of what is needed for maintenance. The balances carried by the company include large amounts that never can be used for the purposes for which the reserve was created. In the long run the amounts thus unnecessarily taken from revenue will reach about one-half the total cost of all depreciable parts of the plant. The only legitimate purpose of the reserve is to equalize expenditures for maintenance so as to take from the revenue earned in each year its fair share of the burden. To the extent that the annual charges include amounts that will not be required for that purpose, the account misrepresents the cost of the service.

"The company's properties constitute a complex and highly developed instrumentality containing many classes of items that require renewal from time to time. But, taken as a whole, the plant must be deemed to be permanent. It never was intended to be new in all its parts. It would be impossible to make it so. Expenditures in an attempt to accomplish that would be wasteful. Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life cannot be accepted as legitimate additions to operating expenses" (pp. 181-82).

The argument thus admirably stated raises two important questions pertinent to the present discussion. The narrower one is whether any economic advantage is to be gained by adopting a system which calls for the creation today of a reserve of the character described by Mr. Justice Butler as "unnecessary"—a reserve which if created at all should have been created in the past, but which has not been called for under the system of railroad accounting heretofore in force. The second is whether there is any principle higher than that of general economic advantage and justice by which accounting practices must be governed and judged.

It is interesting to note the way in which the Commission has dealt with the first point. In its report of November, 1926, it ordered that a reserve account equal to the amount of depreciation which under its new system was deemed to have accrued in the past could be set up on the books of the carriers, and a suspense account of equal amount set up on the asset side. It asserted, quite unjustly I think, that the theoretically correct way would be
to make the charge to profit and loss, on the ground that it represented a failure to accrue depreciation charges in the past; but recognizing the impracticability of this course, proposed that it should remain in suspense until extinguished by charges against profit and loss in the future. Strong exception was taken to these proposals, and in the revised order of 1931 the Commission decreed that the amount of the accrued depreciation at the date when the new system was to become effective should be computed and broken down into component parts corresponding to the primary investment accounts—but that no cognizance of the sum so computed should be taken in the books.

This solution was more realistic than the Commission's previous proposal and was calculated to avert in the case of the carriers such criticism as that expressed later by Mr. Justice Butler in respect to the telephone company. Coupled with a change which required depreciation accounting by groups of units instead of by units (as previously contemplated) it provided a way out of the difficulty of dealing, when retirement occurs in the future, with the depreciation deemed to have accrued in the past on the unit retired. In effect, this depreciation is to be charged against the reserve that is to be created to provide for depreciation in the future. The procedure as laid down is open to several criticisms: it is illogical; it involves the abandonment of a large part of the Commission's theory; and it results in charging against a reserve expenses for which no corresponding credit has previously been made to that reserve. However, the only alternative would have been to require the accumulation of a reserve out of future earnings at the expense either of the shippers or of the security-holders, a course for which there would be no economic justification. Of the two alternative courses, that adopted by the Commission was doubtless the wiser.

Our railroads having reached a state of maturity, there is reason to expect that a depreciation plan on the modified basis would over a period of years produce charges to operation not greatly different from those which would result from the application of a sound retirement method. With the objection to the earlier plan that it added greatly to the burdens upon the carriers' future earnings largely removed, the major question now is whether any advantages sufficient to justify such a change in the general railroad practice of the past, here and abroad, are likely to result from the adoption of the Commission's plan.
A serious demerit of the scheme is its complexity, and the enormous amount of bookkeeping which it would entail. Outside the Commission probably no great virtue will be seen in the fact that with the aid of the extra-accounting statistical record of accrued depreciation at the date when the system becomes effective, it would bring about some sort of coordination between the accounting and the Commission's theory of valuation. A further advantage claimed by the Commission was that the procedure would insure more uniform charges for upkeep against operating in good times as well as in bad. Events since 1931 have already proved the vanity of this hope. We find the Commission itself reporting in 1934 that, although depreciation remained on a pre-depression basis, it had allowed carriers to charge not only certain retirements but also certain repairs against profit and loss instead of against operating expenses.*

Unless the order does bring about a change in the attitude of the Supreme Court as the Commission hopes, and of this there is no present indication, it will, I think, have to be conceded that the results of the activities of the Commission in the matter have not justified the expense they have occasioned. Moreover, the importance of the rate base in the case of the railroads as a whole has steadily diminished as competitive methods of transport have reduced their revenues. Recapture of earnings has gone by the board and railroad valuation has lost most of its former importance.

I shall conclude this series of articles by discussing very briefly the question raised earlier herein, whether there are principles higher than those of general economic advantage and justice by which accounting practices must be governed and judged. Some accountants believe that there are such principles, and it has been suggested that the American Institute of Accountants, or some other body, should undertake to lay them down. It is difficult, however, to see why this should be true of accounting, when it is obviously not true in respect of law or of economics.

The better opinion is, I believe, that, as I suggested in the first of these articles, accounting is a tool of business, and the development of accounting, like the development of business law, should be determined by the best practices of business men. As stated in the report of the American Institute to the New York Stock Exchange of September 28, 1932, out of the necessities of

business there has "grown up a body of conventions, based partly on theoretical and partly on practical considerations, which form the basis for the determination of income and the preparation of balance sheets today."

There is every reason to desire and to expect improvements and a constantly increasing degree of uniformity in accounting conventions. This improvement and this uniformity cannot be attained through any attempt to make accounting practice a reflection of purely metaphysical concepts, but only through careful consideration of what is fair and in the best interest of those having a legitimate interest in accounts. In the case of corporate accounts, this may include stockholders and creditors—actual or potential—employees, customers, and the general public, and nice questions may arise in giving just recognition to the rights of the different groups. Clearly, however, no rule which is contrary to the interests of all of the parties should be established on the sole ground that it conforms to some abstract notion of what is sound accounting.

It is because the best accounting can only be attained through wide knowledge of business, sound judgment and mental integrity that the profession of the accountant offers today one of the most attractive fields of activity to the high-minded and clear-minded among the rising generation.
Special Problems in Accounting for Capital Assets*

BY MAURICE E. PELOUDET

I do not propose to discuss the general principles of valuation or statement of fixed or capital assets. Neither do I propose to discuss, in general, the auditor's or accountant's responsibility for such valuation or statement.

If any one here believes that some sort of present value is the correct basis for stating capital assets and that the auditor should be responsible for the accuracy of such values, I can only say that he is opposed to the weight of the best accounting opinion, and I would recommend to him the series of three articles by George O. May in THE JOURNAL OF ACCOUNTANCY, entitled "The Influence of Accounting on the Development of an Economy," which began in the January, 1936, number, as representing the best present thought and practice of accountants.

If we agree that cost, less proper provision for renewal or replacement, is the accepted basis for stating fixed or capital assets and that this general assumption lies behind all of our accounting for fixed or capital assets we can then consider its particular applications.

As in so many other phases of accounting, the principles are simple but the applications can be surprisingly difficult and awkward. If anyone believes in current appraisals or revaluations as a basis for stating capital assets there is little that the accountant can do for him, as the difficulties resulting from the comparatively simple cost valuations sometimes seem almost insuperable and I believe that the average accountant of fairly wide experience would be willing to admit his incapacity to devise or administer intelligible accounts on the basis of periodical reappraisals.

It is interesting to note that the securities and exchange commission generously and, I think, wisely, refrained from adding to its requirements any provision for valuation or revaluation of capital assets, limiting the demands to a clear statement of the basis on which these assets are carried on the books and shown in the financial statements.

* A paper presented at a meeting of the Providence (Rhode Island) chapter of the National Association of Cost Accountants, January, 1936.
A discussion of accounting for fixed assets should include the reserves applying to them and should cover, as well, items which partake of the general nature of fixed assets but are not generally so classified. The effect on the income account of our fixed-asset accounting should also be considered.

I shall, then, go on to the consideration of a few specific problems in fixed-asset accounting which seem to be important or interesting at the present time. Each question will be handled by itself, and while there are, no doubt, many other aspects of the question which could be considered, the problems discussed are, it is hoped, sufficiently general and representative to be of interest and—I almost said value—but let us say of some use.

**Obsolescence**

Obsolescence is defined as follows:

Report of special committee on terminology of the American Institute of Accountants:

"The basic idea conveyed by this word is that of becoming out-of-date or falling into disuse."

*Oxford Dictionary:*

"The process of becoming obsolete."

*Webster's Dictionary:*

"The state of becoming obsolete."

Obsolescence, it can not be too often repeated, is not a sudden, incalculable loss of value. It is the state of becoming obsolete, and the provision for it should be made before conditions have changed enough to render the plant or other property actually inferior to similar property in competitive use.

Obsolescence can not be provided on a basis of unsupported estimate or surmise. This would cover a mere possibility and might be provided by a reserve for contingencies. Neither can it be provided on a basis of known facts, as this would be equivalent to reserves for physical wear and tear or loss. Reasonable probability, based on experience and generally weighted a little more heavily than that experience would demand as a minimum, is the proper basis for reserving against obsolescence.

Charles F. Kettering, vice-president of General Motors Corporation, was quoted in *The New York Times* (January 4th) on this point as follows:

"Probably the greatest obstacle to recovery is the difficulty of getting rid of obsolescence. Our common sense tells us that, if
every industrial plant in the country suddenly went out of existence, there would be no unemployment, no hard times, no depression. We would all go to work to build new plants.

“But they would not be like the old ones. They would be incomparably better. Now, we don’t need earthquakes to destroy what we have in order to build something newer and better. But there is a reluctance to go ahead and have what we might have because everybody is waiting to recover all possible value from what already exists.

“There, you see, is the problem of getting rid of obsolescence. A man or a company builds a plant to manufacture certain articles. The plant is expected to last twenty or thirty years. But let us suppose that, in only two or three years, a new product is available which makes the output of this plant, as well as the plant itself, out-of-date. Surely the owner should somehow be encouraged to do something new. Not finding such encouragement, he thinks he must keep on using his old plant.

“He even tries by advertising and salesmanship to discourage the public from buying more modern products and to continue using his. If he doesn’t attack what is newer and better, he at least gives the public to understand that the old stand-by is plenty good enough. Thus, this obsolete plant is a detriment to him as well as to the public. It slows down progress.

“But let us suppose the government should say to every manufacturer: ’We won’t levy much tax on your plant during the first three years. It won’t even be much during the following four or five years. From then on, though, we’re going to increase the rate, and, before your plant is twenty years old, it will be so high that it will be cheaper for you to tear it down and build a new one.’”

Admitting that this is hardly a statement of a considered program or plan we must agree that it goes directly to the root of the matter so far as economics and business are concerned. If every business man took, and was encouraged to take, Mr. Kettering’s view and put it into practice to the extent of discarding obsolete machinery as soon as it became obsolete there is little doubt that the industrial plant of the country would be in far better shape than it is and production both of consumers’ goods and the products of heavy industry would be greatly increased to the advantage of everyone.

While the accountant does not as a rule have the technical knowledge necessary to decide whether or not a particular machine or building is obsolete, he does know in a general way, from the financial and operating statements, the condition of a plant so far as obsolescence is concerned. It is his duty to point out
the existence of this condition wherever he knows or has reason
to believe that this is the fact. He should advise the management
to obtain technical advice, either from its own staff or outside
engineers, as to the extent and nature of such obsolescence from
a technical point of view and, if the condition is sufficiently
serious, he should call the attention of stockholders and investors
to it through his certificate or accounts.

There are many influences which cause the business man to
doubt his own innate good sense and judgment when he is faced
with the problem of providing for obsolescence or of scrapping
obsolete machinery.

Government, through its taxing policy, both local and federal,
positively encourages holding on to the old plant as long as the
wheels will creak around or the buildings stand.

The United States treasury department has never been liberal
in its allowances for wear and tear, but prior to the 1934 revenue
act it permitted some small addition to rates of depreciation to
cover obsolescence. Under treasury decision 4422 and the 1934
revenue act the deduction for obsolescence is still reserved to the
taxpayer under article 23 of regulations 86, but the treasury
department’s insistence on expected or remaining life has a
tendency to give undue weight to known factors and perhaps an
equally strong tendency to minimize the importance of factors
such as expected or anticipated obsolescence, which can not be
specifically proven at the time the charge for depreciation is made.

Under a recent treasury decision (I. T. 2944—Internal Revenue
Bulletin No. 50-XIV) it is possible that the taxpayer might be
denied a deduction for obsolescence in any particular year which
subsequent events might show should have been taken. This
would then be considered as additional “allowable deprecia-
tion,” and, if any of this applied to a year in respect of which the
statute of limitations had expired, the deduction for the obsoles-
cence heretofore denied would be applied to the taxpayer’s depre-
ciation base, but no adjustment of tax for that year could be made.
This does not seem entirely fair to the taxpayer, but I do not see
how the decision can be interpreted in any other way. The
language of the decision is:

“The word ‘allowable’ designates the amount permitted or
granted by the statutes, as distinguished from the word ‘al-
lowed’ which refers to the deduction actually permitted or granted
by the bureau. The amount ‘allowable’ is the minimum for
adjustment purposes, the amount ‘allowed’ serving to measure the adjustment only when the amount thereof exceeds that allowable.

"It follows that the depreciation claimed as a deduction in a return which has been accepted by the bureau is the amount ‘allowed’ for that year. The amount thus ‘allowed’ for any year may be adjusted to the amount ‘allowable’ at any time within the statutory period applicable thereto for purposes of computing the proper deduction for such year and of adjusting the basis. The statute, however, requires adjustment of the basis to accord with the amount ‘allowed’ or the amount ‘allowable,’ whichever is greater, irrespective of any statute of limitations applicable to the year of deduction.”

In itself the collection of an excessive tax from a company does not necessarily influence the policy as to fixed assets and depreciation. But where this tax is collected by the assertion that excessive provision has been and is being made for depreciation, the effect may be, especially in smaller concerns, to induce a company to adopt unsound practices, overstating or anticipating profits, merely because such policies swell current income to the profit of the taxing body.

If rates of depreciation obviously inadequate or barely adequate for wear and tear only are forced on a company by the treasury department, the company is not thereby absolved from the consequences of making only such clearly inadequate provision for wear and tear nor from the results of failing to provide for obsolescence.

High costs, inferior product, delayed deliveries, inability to meet specifications will dog the footsteps of the manufacturer who fails to discard obsolete and obsolescent machinery or to modernize his plant and processes, whether or not the treasury department or any other authority tells him he has provided adequately for the retirement of his plant or for its renewal.

If we assume that for every enterprise for each period there is an “ideal” or “true” income we shall find that accountants under the accepted principles and customs of commercial accounting generally arrive at an income which approximates but does not reach this ideal figure. The treasury department under its methods of accounting also approximates this true or ideal income, but the income is generally in excess of the ideal. Obviously if both commercial accountants and treasury department accountants accomplished their purpose completely, they would arrive at the same income but from opposite sides and by different
methods. Where there is a conflict between general accounting practice and treasury department accounting, the tendency of the accounting methods advocated by the treasury department is to delay the application of expenses paid in advance or to minimize the provision for depreciation or similar charges and to anticipate the realization of income where this is in any way indicated. General accounting practice, based largely on the custom of prudent business men, is to anticipate losses by means of reserves or to accelerate write-offs of expenses wherever this is possible and to delay taking profits until realization is complete or reasonably certain within a short time. It is for these reasons that discrepancies between corporate and taxable income are inevitable.

**Funding Depreciation Reserves**

Funding depreciation reserves has attracted some attention lately but has not received, so far as I know, adequate and thorough treatment by any authority. Some proposals can only be described as fantastic. One of these, put forward in all seriousness, is to purchase each month selected common stocks to the amount of the depreciation provision, the theory being that these stocks will go up or down exactly as commodity prices increase or decrease and that, therefore, the stocks constituting the fund corresponding to the reserve will always represent replacement value of the depreciated property. This has about the same degree of probability as the proposition of A. S. Eddington who says, in discussing the laws of chance in *The Nature of the Physical World*, that "if an army of monkeys were strumming typewriters they might write all the books in the British Museum" but I do not think the probability is much greater.

However, there are some cases where funding depreciation reserves is a prudent business policy. To take the extremes, in a business where the entire plant will need to be renewed after the lapse of a comparatively short time it would be well to have available cash or readily realizable securities of the amount needed for the new plant. The wisdom of funding depreciation reserves is obvious in industries of a particularly hazardous nature such as the manufacture of high explosives. Here risks must be taken for which no insurance coverage is available and where there is always the possibility that all or part of the plant would have to be replaced on the very shortest notice. In fact the management
might be subject to severe criticism if provision of cash to meet such emergencies were not made. It might also be well to segregate these assets from the ordinary current assets to indicate that they are not available for distribution to stockholders.

At the other end of the scale is the plant where, to keep up satisfactory operation at normal capacity, about as much needs to be spent for new machinery or construction as is charged for depreciation. Here no funding is required, as the cash is spent at about the same rate as the provision for depreciation is made and the original cost remains as the net figure, additions balancing depreciation.

Most plants lie somewhere along the scale between these extremes—generally closer to the situation last described. As a fair, rough, general rule, where the policies of funding reserves has been adopted, it might be assumed that the fund should equal the accumulated provision for depreciation on existing plants less the additions to such plants necessary to keep them in operation at their original capacity, but the purpose of the fund is not to provide for new plants or additional capacity.

For instance, a coal mine might be equipped with a tipple costing say, $100,000. At the end of ten years $50,000 depreciation might be written off and additions necessary to keep the tipple in operation amounting to $10,000 might have been made. Ten thousand dollars of the provision for depreciation has been spent and might properly be charged to reserve for depreciation, and if the reserve were funded the fund should equal $40,000. For the sake of simplicity no consideration has been given in the foregoing to the increase of the fund through compound interest, but in the practical application this would have to be taken into account in determining the amount set aside.

The basic assumption behind funding depreciation reserves is sound, that is, that depreciation is an expense—the cash payment of which is, from the point of view of replacement, deferred—which, if the business is to continue, is as certain as payments for material or wages. This being so, depreciation should be provided in cash and it is not material whether this cash is expended piecemeal, from time to time, or in a lump sum when the property is sold or dismantled. If not provided it should be fully realized that present investment of funds representing provision for depreciation is, in effect, an anticipatory use of the company’s future borrowing capacity.
INVENTORIES AS FIXED ASSETS

We all know what are usually considered to be fixed assets, but there are other items which are generally and conventionally classified as current assets which sometimes partake to a large extent of the nature of a fixed investment. It is generally recognized that advances to affiliated companies or to others, which it is not intended should be repaid within a year, should be included in the same classification as investments, but a similar segregation of inventories which can not or will not be sold within a year is seldom made. At first sight it would appear strange and perhaps alarming to consider any part of the inventory as a fixed asset but there is, I believe, a steadily growing body of opinion which inclines to this view. When we discuss accounting for fixed assets we have in mind the investment features more than the physical ones, and the investment in raw material which must be maintained so long as a plant operates would seem to be a fixed asset regardless of the fact that the individual units of material may pass through the process and be delivered to customers.

In the January, 1936, issue of The Journal of Accountancy, Howard S. Thompson in an article on “Oil inventories accounting” says, “It may fairly be urged that the fixed quantities of oil which must be permanently maintained in tanks with floating covers, in pipe lines, and under other comparable conditions, are a part of the permanent investment which is necessary to insure a most effective use of the physical equipment.”

In the annual report of the American Smelting and Refining Company for the year ended December 31, 1934, it is stated: “An amount of each metal in process is as necessary to the conduct of business as the smelting and refining plants themselves and your company has accumulated the amount of each metal it must have in process under normal conditions which resembles a reservoir. It would have to sell each day from the outgoing end of the reservoir an amount of each metal equal to that taken in at the incoming end. The metal content of the reservoir is known as ‘normal stock’.”

One interesting feature of the trend of opinion towards considering normal stocks as a fixed asset is that this movement originated primarily in the thought and practice of business men and was more slowly adopted and taken up by accountants. The principle is not difficult to understand—that is, if we must keep
fixed quantities of raw material we should not revalue them annually or monthly at replacement costs any more than we should revalue our buildings or machinery on such a basis. The applications, however, of this principle are sometimes complex and difficult but in the industries to which this method is suited these difficulties can be overcome.

The results, in the form of income accounts which show profits or losses based on actual current operations, are generally found to be worth the labor involved in devising a system which will eliminate profits or losses arising from revaluation of fixed inventories on any replacement basis.

At present it is probably impossible to do other than respect generally accepted accounting conventions which dictate that inventories shall be classified as current assets and that they shall not be valued at prices higher than market. However, it is quite possible to devise means whereby any adjustments resulting from the classification of fixed inventory as current assets may be eliminated from the current operating results either through surplus adjustments or by segregation in the income account after a current operating income has been ascertained.

**Wasting Assets**

A special type of capital asset is that known as the "wasting asset," typified by mining claims, oil wells, quarries and the like. Companies engaged in exploiting this type of asset are neither legally nor as a matter of business practice required or expected to maintain original capital values, even though in some cases the estimated amount of exhaustion is indicated. To take an extreme and simple case, let us assume that a mining company owns a small and highly profitable claim which, it has been determined, will be exhausted in, say, five years. Accurate data as to costs and metallic content are assumed to be available which indicate that an operating profit of, say, $200,000 a year will be made. The discoverer of the mine capitalizes the company at 700,000 shares of $1.00 par value each, of which he retains 500,000 for himself and sells 200,000 for working capital and platt. During the five years dividends of $200,000 a year are paid. The mining property stands on the books at $500,000. I do not think in a case like this any one can argue that the management is responsible for always maintaining intact assets equal to the original value. To do this would mean withholding one-half of all
amounts paid as dividends and at the end of the five years the company would have a worked-out mine, a fully depreciated plant and $500,000 in cash. The only thing which could be done with the cash would be to pay it to the stockholders as a liquidating dividend or to reinvest the money.

The usual practice in a case like this would be to pay out in dividends all the moneys realized in excess of what was necessary for working capital for operations. As a rule there would be no writing-down of the mining property and at the time the mine was exhausted we should still, under ordinary practice, show mines and mining claims of $500,000 against capital stock of $500,000. No one, however, with any experience in mining investment would be deceived, as the intelligent mining investor does not look to the balance-sheet to determine the value of his property nor does he assume that all the dividends he receives are income. He knows very well that some part of them represents return of capital. The balance-sheet indicates the company's current asset position and the cost and depreciated value of fixed assets, including plant, other than mining property. The value of the mining property is most easily determined from engineering and operating statistics, which are an important part of a mining company's report and form the basis for the intelligent investor's determination of the allocation of his dividend as between income and capital. The figures shown for property generally represent nothing more than the original cost or the original capitalized value. The alternative to this is the writing off of depletion on cost, which would involve revaluing the property whenever new discoveries of ore, not contemplated in fixing the original rate, were made. This does not mean that the total cost value of the mine would be different, but the total cost would have to be spread over a greater number of units of metal. This, in turn, would indicate that the earlier depletion rate was incorrect and would, if a correct valuation was to be maintained, involve a recalculation of past depletion at the rate then known to be more nearly correct than that previously established. The number of revaluations which would be necessary under this method would be limited only by the number of new determinations of recoverable units of metal. Advances in metallurgy, making possible the treatment of ore's formerly considered worthless because of low grade or difficulties in reduction or smelting, would also cause a similar revaluation. These are not peculiar or unusual condi-
Special Problems in Accounting for Capital Assets

tions but, to a greater or less degree, are common to most mining enterprises of any size or complexity, and they would introduce so many complex and confusing elements, largely based on future possibilities, that actual operating results might be seriously obscured or distorted by the introduction of such deductions and additions into the income and surplus accounts.

The problem in this example is a simple one, but the same principles and methods apply where the situation is much more complicated. It is unusual to be able accurately to estimate for a mining property of any magnitude the probable extent of the ore body or the content and extraction cost of the ore. It is impossible to foretell over an assumed period of operation the future course of metal prices. Herbert C. Hoover, in his book Principles of Mining, says:

"It should be stated at the outset that it is utterly impossible accurately to value any mine, owing to the many speculative factors involved. The best that can be done is to state that the value lies between certain limits, and that various stages above the minimum given represent various degrees of risk. Further, it would be but stating truisms to those engaged in valuing mines to repeat that, because of the limited life of every mine, valuation of such investments can not be based upon the principle of simple interest; nor that any investment is justified without a consideration of the management to ensue. Yet the ignorance of these essentials is so prevalent among the public that they warrant repetition on every available occasion.

"In general it may be said that the lower the total annual return expected upon the capital invested, the greater does the amount demanded for amortization become in proportion to this total income, and therefore the greater need of its introduction in calculations. Especially is this so where the cost of equipment is large proportionately to the annual return. Further, it may be said that such calculations are of decreasing use with increasing proportion of speculative elements in the price of the mine. The risk of extension in depth, of the price of metal, etc., may so outweigh the comparatively minor factors here introduced as to render them useless.

"In the practical conduct of mines or mining companies, sinking funds for amortization of capital are never established. In the vast majority of mines of the class under discussion, the ultimate duration of life is unknown, and therefore there is no basis upon which to formulate such a definite financial policy even were it desired. Were it possible to arrive at the annual sum to be set aside, the stockholders of the mining type would prefer to do their own reinvestment. * * * *"
Copper mining companies are probably the most important group among the producers of non-ferrous metals. Under present conditions this industry requires the investment of large amounts of capital to work deposits of ores which in most cases present special chemical and mining difficulties by reason of their low grade, geological peculiarities or the inaccessible situation of the mines. None of the larger copper mining companies operating in the United States attempts to show a deduction for depletion in the published accounts on a basis of cost of property to the company. All companies, of course, enter on their books values and depletion reserves as determined for purposes of federal income taxes. This is a special calculation for a special purpose and, while presumably correct for that purpose, it does not represent exhaustion of capital from the point of view of the company or the stockholder.

Of seven copper mining companies, representing approximately three-fourths of the United States domestic production, two of the smaller ones charge the amount of depletion as arrived at for federal income-tax purposes to income. Another large company shows its properties at the United States treasury department valuation, arrives at its income before depletion and shows treasury department depletion as a deduction from surplus. The other four companies, which account for nearly one-half the domestic production, carry their properties at cost and do not show any provision for depletion in their financial accounts. They follow the custom of the industry so far as the publication of statistics is concerned.

Companies operating in Canada, Mexico and Africa follow much the same procedure. Certain South American companies owned in the United States make a charge for depletion which, while the basis is not stated, is presumably that arrived at for federal income-tax purposes. Others, and these include most of the larger companies, make no such provision and so state in their accounts.

One of the largest African producers solves the problem of depletion in an unusual manner. The mining rights and properties are written off completely and no value is placed on the stock which was presumably issued against these assets. Here the company has written off all the depletion possible but at the same time this charge is excluded from the income account as effectually as if the properties were maintained at cost and no depletion
whatever were written off. This is a case of the meeting of extremes and either method is probably acceptable so long as the facts are fully stated.

Another important non-ferrous metal is lead. Of eight representative lead mining companies four make a charge to income for depletion. In one case it is definitely stated that this depletion is that determined for federal income-tax purposes, and it is presumably so in the other three cases. The other four companies do not make any charge for depletion in their income or surplus accounts. It is interesting to note that in the case of the largest company of the group the depletion allowed for federal income-tax purposes was adjusted in 1935 by the treasury department, which resulted in the reduction of the annual depletion charge by approximately 80%. This was presumably the result of a determination by the treasury department that the value assigned to the mining property as at March 1, 1913, should be distributed over a larger number of recoverable pounds of lead than was estimated to be contained in the various deposits as at March 1, 1913.

In the coal mining industry it is the custom to charge depletion in the accounts, generally on a cost basis. The conditions surrounding the mining of coal frequently permit the calculation of depletion based on cost with a fair degree of accuracy.

As in many other cases the general practice of business men and their technical advisors is probably the best guide for the accountant. If those responsible for the conduct of an industry, after consultation with their own and independent technical men, after consultation with legal counsel and after having received the views of stockholders and others financially interested, decide on a course of action which is followed consistently over long periods by a substantial part of an industry, it would seem that the accountant should not endeavor to change this practice unless he is possessed of overwhelming evidence that executives, technical men and legal and financial counsel are all clearly wrong. The mere statement that those responsible for companies exploiting wasting assets do not follow the same accounting methods as those responsible for the operation of factories and mercantile establishments would seem to have little weight or bearing. As a rule the investor in the securities of companies exploiting wasting assets has at his command better and more comprehensive statistical data than can be obtained for most manufacturing or trading industries. Such an investor must always bear in mind that the
financial statements can only be read intelligently in conjunction with such statistical data and the company’s own reports.

CONCLUSION

I am not sure that I have given you what you wanted or expected. The National Association of Cost Accountants is an intensely practical body and I feel that I have perhaps overstressed the broad relationship of accounts to economics and investment and have perhaps neglected immediate and practical applications. But anyone who is responsible for the preparation of statements which are used by executives is responsible to some degree for shaping the policies of the organization whether he wishes to be so or not and whether or not he realizes that he is doing it. In every case this responsibility exists, whether recognized or not, and in many cases the management expects this sort of judgment from the accounting department without specifically requesting it, as the management realizes instinctively that this is an essential function which, if it is to be exercised at all, must be carried out by the accounting department.

Accounting statements, no matter how prepared, must make an impression of some sort and it is the duty of the accountant, whether privately or publicly employed, to see that the impression which is given is not only correct but truthful. By this I mean that if, for instance, a statement were prepared, showing for a company $100,000 profit in a quarter and $10,000 depreciation charged off, the statement might be correct mathematically and might be a correct transcription of the company’s records. If it were known that the provision for depreciation was grossly inadequate it would not, however, be a true statement and whoever was responsible for the preparation of the statement would be neglecting his duty if he did not point this out. It seems to me that the most certain protection from preparing statements which are correct but untrue is to understand the financial, economic and, perhaps, even legal significance of the statements and figures prepared and presented. No one can be expected to prepare a statement and to understand all its implications, but the closer we approach to that the more truthful and useful our statements will be. The element of judgment is present to some degree in even the simplest accounting statement, and the surest way to see whether that judgment has been properly exercised or not is to sit down quietly with the statement for a few minutes and try to realize fully what it means as well as what it says.
Coöperation of Accountants with Bench and Bar*

BY WALTER A. STAUB

One of the fundamental contributions to the development of civilization has been the division of labor. This is commonly associated with the ever-increasing segregation of some one function of manual or physical labor to one person—in contrast to a state in which each man performs a variety of productive or distributive functions—and with the increased use of machinery with its accompanying tendency to develop the ability to operate a machine for one given purpose and not a general ability to operate any one of a number of types of machines. The tendency toward the division of labor has, however, manifested itself, not only in the field of physical labor, but also in the field of mental or intellectual effort.

With the continued development and increasing complexity of modern civilization, new professions have arisen or an older profession has given rise to several new ones. In the Christian era, academic education was for centuries in the control of, and instruction was imparted by, the church. The earliest of our colleges owe their origin to the church. In colonial days many ministers taught school in addition to carrying on their preaching and pastoral duties. Today, however, it is recognized that the teacher—whether in the elementary schools or in institutions of higher learning—has a task which is big enough to require all of his time and attention for that one thing, and that he requires special training for that one calling, if he is to perform his task satisfactorily.

A few centuries ago the barber not only rendered services of the kind which we associate with that occupation today, but he also served in the field of medicine by cupping and leeching patients who were thought to require bloodletting. Perhaps, unconsciously, that was an ancient method of dealing with high blood pressure! I was told recently by a physician that at one time barbers, under a physician's direction, also performed such surgical services as cutting off a leg, and that modern surgery evolved from such earlier practice.

Architecture and engineering were at one time merged in one

*An address delivered at a meeting of the New Jersey Society of Certified Public Accountants.
practice much more than is the case today. We admire Leonardo da Vinci for his great variety of talents and abilities and speak of him as having been, among other things, both an architect and engineer. In his day (15th and 16th centuries), however, it was probably much more common for today's separate callings of architect and engineer to be combined in one person than otherwise.

I am not very familiar with the history of law and lawyers, except to know that one finds reference thereto in the Old Testament and other sources of ancient history. (One of my lawyer friends, in commenting in a semi-jocular vein on the advantage lawyers have over accountants in that they never give "certificates" but merely express "opinions," called attention to the following reference to lawyers in the New Testament, when Jesus is quoted as having said, "Woe unto you lawyers! for ye lade men with burdens grievous to be borne, and ye yourselves touch not the burdens with one of your fingers."—Luke 11: 46.) Doubtless, the legal profession developed from primitive beginnings and possibly its early practitioners did not confine themselves to that calling exclusively. For centuries past, however, it has been one of the learned professions and has enjoyed recognition second to none. It is interesting to note, though, that changing conditions have had their influence in this long established profession as in other callings.

Some years ago I read an article in the Princeton Alumni Weekly in which an alumnus, who was a lawyer in New York, described the changes which had been taking place in the practice of law in that city. He mentioned particularly the growth of outstanding firms with large offices and extensive organizations and contrasted this with the individual practice so generally characteristic of an earlier day. Doubtless, he did not intend to intimate that the lawyer with a small or modest sized practice no longer existed, but rather that the tremendous expansion of business in modern times and the extended use of the corporate form for conducting business, accompanied by the widespread holding of corporate securities, had led to the growth and development of large law offices whose extensive practice is largely devoted to business affairs.

I should like to refer briefly to the development of accountancy as a profession because it is so comparatively recent, and all our guests of the evening may not be familiar with it.
Accounts and accounting are as old as business and property; almost half a millenium ago, when Venice was at her height as the leading commercial power in Europe, we find Pacioli writing a treatise which recognized double-entry bookkeeping as well developed and presented that fundamental concept of debit and credit which underlies, not only highly developed accounting, but modern business itself and is a fundamental element in the language of business. The practice of accountancy as a profession, and as we know it today, is, however, of recent origin. Even when Sir Walter Scott in 1820 referred to accountancy as a possible profession for his nephew, no one of the societies of professional accountants which are today well known in Great Britain was yet in existence.

Sir Walter's letter, which was dated July 23, 1820, and written from Abbotsford to his brother, Thomas Scott, a paymaster in the British army, is interesting among other things for its implication that professional accountancy at that time was a branch of the legal profession. As given in Lockhart's *Life of Scott* (Vol. VI, p. 223), it reads as follows:

"After my own sons, my most earnest and anxious wish will be, of course, for yours, and with this view I have pondered well what you say on the subject of your Walter; and whatever line of life you may design for him, it is scarce possible that I can be of considerable use to him. Before fixing, however, on a point so very important, I would have you consult the nature of the boy himself. I do not mean by this that you should ask his opinion, because at so early an age a well bred up child naturally takes up what is suggested to him by his parents; but I think you should consider, with as much impartiality as a parent can, his temper, disposition and qualities of mind and body. It is not enough that you think there is an opening for him in one profession rather than another, for it were better to sacrifice the fairest prospects of that kind than to put a boy into a line of life for which he is not calculated. If my nephew is steady, cautious, fond of a sedentary life and quiet pursuits, and at the same time a proficient in arithmetic, and with a disposition towards the prosecution of its highest branches, he can not follow a better line than that of an accountant. It is highly respectable—and is one in which, with attention and skill, aided by such opportunities as I may be able to procure for him, he must ultimately succeed. I say ultimately—because the harvest is small and the labourers numerous in this as in other branches of our legal practice; and whoever is to dedicate himself to them must look for a long and laborious tract of attention ere he reaches the reward of his labours. If I live, however, I will do all I can for him, and see him put under a
proper person, taking his 'prentice fee, etc., upon myself. But if, which may possibly be the case, the lad has a decided turn for active life and adventure, is high-spirited and impatient of long and dry labour, with some of those feelings not unlikely to result from having lived all his life in a camp or a barrack, do not deceive yourself, my dear brother—you will never make him an accountant; you will never be able to convert such a sword into a pruning-hook; merely because you think a pruning-hook the better thing of the two. In this supposed case, your authority and my recommendation might put him into an accountant's office, but it would be just to waste the earlier years of his life in idleness, with all the temptations to dissipation which idleness gives way to; and what sort of a place a writing-chamber is, you can not but remember. So years might wear away, and at last the youth starts off from his profession and becomes an adventurer too late in life, and with the disadvantage, perhaps, of offended friends and advanced age standing in the way of his future prospects."

Just why young Walter did not enter an accountant's office we are not told. In 1822 Sir Walter, in writing to his own son who was in the army, says of his nephew, "The little fellow studies hard . . . if you do not take care he may be a general before you." He died a general in 1873.

It was only in 1854 that the earliest of the present British societies of accountants, the Society of Accountants in Edinburgh, was organized under a royal charter. Incidentally, I'll leave it to you for rumination whether there is any significance in the fact that societies of accountants were first formed in Scotland!

In England the accountant has long enjoyed an honored position in the business world and a high social status, but it is only fifty-five years since a royal charter was secured for the Institute of Chartered Accountants in England and Wales. In our own country, we shall not celebrate until 1937 the fiftieth anniversary of the founding of the American Association of Public Accountants, the lineal predecessor of the present American Institute of Accountants. It is only thirty-nine years since New York enacted the first certified public accountant law in this country and it was thirty-one years ago that our own state of New Jersey enacted a similar law.

But life moves swiftly in these modern times. Those of us who have been active in professional or business life in the past quarter century have seen the development of the accountancy profession proceed with unexampled rapidity. Three years ago I

202
Coöperation of Accountants with Bench and Bar

had the privilege of participating in the meeting of our society, which commemorated the thirty-fifth anniversary of its founding. In speaking on "The development of accountancy during the past thirty-five years," I referred among other things to the relation between the lawyer and accountant as I had observed it in the years immediately following upon my entry into the office of my firm as a junior assistant in 1901. My birthplace was Philadelphia—that city which according to a popular adage produces lawyers who can unravel the most complex situations—and it was in that city in which I received my education and early training. I recall that in those days of a generation ago, a Philadelphia lawyer would not have considered an accountant as being in the same class with himself professionally, and comparatively few people either knew of public accountancy or thought of it as a profession. When an accountant was required to perform work in which the lawyer was interested, the latter usually arranged it for his client, and it would hardly have occurred to the lawyer to have the accountant present at a conference with the client to discuss the results of the work done. The lawyer felt quite competent to do that himself after the accountant had reported to him.

Today, the condition is entirely changed. The lawyer and also the banker and the engineer with whom the accountant likewise has much contact, all welcome the full measure of coöperation from the accountant and look to him to work with them on a basis of substantial equality and to share with them the burdens and responsibility of the service which may be required when two or more of these professions come in contact while serving a mutual client.

During the past century a transformation has been going on in our country from the relative simplicity of agricultural communities to the complexity of more and more extensive manufacturing, trade and transportation, with their accompanying functions of banking and finance. This development has tended to produce many more, and a different type of, cases in which the services of lawyers and accountants are essential and their close coöperation imperative than would be the case in a predominantly agricultural country.

In a country which is primarily agricultural, the matters coming before courts and in lawyers' offices would presumably relate largely to fiduciary matters, such as wills and trusts, to property rights in which few parties are involved, to domestic relations,
etc. In a highly industrialized state of society, however, such as
now exists to so great an extent in our country, many more
complicated matters of quite a different type require the attention
of the bar and of accountants, such as offerings and sales of securi-
ties based on representations through financial statements,
corporate reorganizations, developments arising out of the ex-
tension of banking and commercial credit, complicated bank-
ruptcies, the consideration of involved business contracts, and
so on.

The transformation has been especially marked since the so-
called "trust era" of the nineties, and not only has brought with
it a need for the continued development of the accountancy pro-
fession, which had not previously been felt, but also has empha-
sized the growing need of the closest coöperation between lawyers
and accountants.

Some years ago close coöperation began between various or-
ganizations of professional accountants and the Robert Morris
Associates. The membership of the latter organization (named,
you will note, after the great banker of our Revolutionary war),
which is national in scope with local chapters in various cities,
consists of credit executives of banks and other credit-granting
agencies. The coöperating committees of accountants and Robert
Morris Associates have rendered a most useful service in aiding
credit executives to obtain a better understanding of financial
statements presented to them by seekers of credit and of the sig-
nificance of the reports and certificates by accountants in respect
of such statements. On the other hand, accountants have gained
a better understanding of the manner in which credit executives
view the statements presented to them and are thus the better
able to serve their clients who may be credit seekers. The coöp-
eration between the accountants and the Robert Morris Associates
had such valuable results that similar committees were later
appointed for coöperation between accountants and the Invest-
ment Bankers Association of America. These committees, too,
have made progress in helping the members of each group to
understand better the work and functions of the other, and the
way that they might best coöperate to serve their mutual clients.

A similar procedure has begun between accountants and law-
yers. The American Institute of Accountants has appointed a
special committee on coöperation with bar associations. That
committee has conferred with a committee of the American Bar
Coöperation of Accountants with Bench and Bar

Association on matters of mutual interest. The New Jersey Society of Certified Public Accountants is endeavoring to aid in this movement through the appointment of its committee on coöperation with bench and bar, and in securing the appointment of a corresponding committee by the Essex County Bar Association and other bar associations in the state.*

Such coöperation between lawyers and accountants should be helpful in leading to a better understanding of each other’s respective fields and in avoiding trespass thereon, not merely for the sake of the respective practitioners but even more for the sake of their respective clients. The accountant should have some general knowledge of those principles of law which have their application primarily in the field of commerce and finance. In fact, the certified public accountant examination in all states, I believe, includes the subject of commercial law. The object of this knowledge on the part of the accountant is not to determine questions of law or to prepare legal documents but rather to understand the significance of contracts, negotiable instruments, bond and preferred stock indentures, and business transactions generally in their application to accounts and financial statements. The Columbia University law school has, I understand, correspondingly recognized the helpfulness to the lawyer of some knowledge of accounting and has been carrying on an experiment in having law students take some work in accountancy and in corporation finance in the university’s school of business. Necessary the time of the student is limited, and it is not intended to make an accountant of the law student or to enable the lawyer when he eventually enters into practice to be his own accountant. I need not remind you of the old adage concerning the nature of the client the man has who attempts to act as his own counsel. It is intended rather to give the lawyer a better understanding of the accounting problems that may arise in his practice and better to fit him for intelligent coöperation with the accountant who will participate in such a case.

Further, such knowledge aids the accountant in deciding when any question arises upon which the opinion of counsel should be obtained before the accountant determines finally the effect which should be given to certain transactions or a state of facts in the financial statements which he is preparing to certify.

*Since this address was made the New Jersey Bar Association and several county bar associations have appointed committees to coöperate with the committee on coöperation with bench and bar of the New Jersey Society of Certified Public Accountants.
The Journal of Accountancy

I believe accountants generally are well aware of the warning, "a little learning is a dangerous thing" and that they have no desire to usurp the functions of the lawyer—that on the contrary, they are keen to have his aid and advice whenever possible. In the experience of our own office there have been many occasions on which we have called to the attention of clients the desirability, or even necessity, of referring to counsel matters which have come to our attention in the course of accounting engagements.

With the increasing complexity of modern business and finance, and the continued development of the accountancy profession and a better knowledge of the services it can render, those lawyers whose practice relates particularly to the business and finance of corporations and related matters have in turn recognized the danger of attempting to decide important accounting matters without the aid and advice of accountants. However, there is room for increased coöperation in this field. I think the lack of it that may exist at the present time is due largely to a lack of consciousness of its helpfulness.

In our office we were recently shown a draft of a proposed indenture for a security to be issued incident to a corporate reorganization, which contained a number of provisions of an accounting nature. Any accountant, upon even a cursory reading of the provisions referred to, would have recognized their impracticability and their failure to carry out effectively the intent of those interested in the reorganization. This is a case where coöperation between lawyer and accountant in the drafting of such provisions would have been most helpful to client, lawyer and accountant, because of the elimination of difficulties which might arise later from impracticable or ambiguous provisions. Examples of other contracts, in the drafting of which, or of litigation arising therefrom, the lawyer and accountant may advantageously coöperate are cost-plus contracts, provisions relative to the book value of capital stock which may be the subject of sale or purchase after the death or withdrawal of a partner or stockholder, and so on.

In suggesting some further ways in which lawyers and accountants may coöperate to mutual advantage, I shall not attempt to do so in any exhaustive way. I might mention incidentally that this was well done by the president of this society in an address on "bench and bar and the accountancy profession," which he
Coöperation of Accountants with Bench and Bar

delivered at the annual meeting of the convention of certified public accountants in Atlantic City a year ago. I wish merely to indicate some methods of coöperation which may in turn be suggestive of still others.

The field of corporate finance and accounts is a broad one for coöperation, as I have already indicated. Included in it are matters which have a distinctly legal aspect and on which the opinion of counsel is frequently needed by the accountant and in respect to which, on the other hand, the accountant may be able to assist the lawyer in making clear the accounting implications or the effect upon clients' financial statements. Among them are such matters as incorporation and capitalization, the status of liabilities, particularly those of a contingent nature, title to property and construction of contracts. In financing operations, including the offering of securities to the public, the lawyer and the accountant must necessarily be in very close contact with each other, whether their client be the issuer of securities or the underwriter.

Important questions are involved in both the legal and accounting aspects of financial statements included in a prospectus. The necessity for close coöperation in such matters has become even greater since the enactment of the securities act of 1933 and the securities exchange act of 1934. The liabilities resting upon directors and officers of corporations which register securities under either of those acts and the liabilities of accountants and other so-called "experts" participating therein are very serious. The greatest precaution, therefore, needs to be taken with respect to every financial statement included in registration statements filed with the securities and exchange commission or listing applications filed with any stock exchange, so that no inadvertent misrepresentations or lack of adequate disclosure may occur.

I need hardly refer to the field of taxation because in it lawyers and accountants have had a great deal of coöperative contact on behalf of their mutual clients during the recent years. This coöperation becomes especially important when the case involves federal taxes and has gone beyond the treasury and to the board of tax appeals. Both lawyers and certified public accountants are allowed to practise before that board. Inasmuch, however, as the procedure before the board is a formal one, with legal rules of evidence in the trial of cases, and with appeals from the board's decisions going to the circuit courts of appeal, it is, in my opinion,
usually unwise for an accountant to attempt to present a case before the board without being associated with legal counsel. On the other hand, since cases coming before the board of tax appeals so often involve matters of accounting even more than pure questions of law, it would seem that in a case of any importance a lawyer would be well-advised to have the aid of accounting counsel.

A field of cooperation which does not usually involve a productive engagement, at least for the time being, but one calling for the rendering of public service, is that of legislation where it is of a kind which both lawyer and accountant can be helpful in drafting. In recent years the states of Ohio and Illinois, and possibly some others, have enacted new business corporation laws to take cognizance of important business and financial conditions. Subjects of serious import from the standpoint of corporation finance have sometimes not even been mentioned, or at most have been touched upon only cursorily, in older corporation laws. For example, questions relating to treasury stock, earned surplus as contrasted with capital surplus, dividends from sources other than earnings, etc., were the subject of long and careful consideration between committees of lawyers and accountants in the drafting of the newer corporation laws.

In the formulation of taxing statutes and of such legislation as the social security act, lawyers and accountants might well be helpful in making sure that proposed provisions are fair, unambiguous and apt to avoid accounting or other practical difficulties in their administration.

An example of practical and successful cooperation was the combined opposition of lawyers and accountants to senate bill 2512, introduced at the 1935 session of congress. Although the ostensible purpose of the bill was to regulate or control lobbying in congress and government departments, its language was so broad that it might have interfered seriously with the legitimate representation of clients by lawyers and accountants. This is evident from the following provisions of the bill:

"... any person who shall engage himself for pay, or for any consideration, to attempt to influence legislation, or to prevent legislation, by the national congress, or to influence any federal bureau, agency, or government official, or government employee, to make, modify, alter, or cancel any contract with the United States government, or any United States bureau, agency, or offi-
Coöperation of Accountants with Bench and Bar

cial, as such official, or to influence any such bureau, agency, or official in the administration of any governmental duty, so as to give any benefit or advantage to any private corporation or individual, shall before entering into and engaging in such practice with reference to legislation as herein set out register with the clerk of the house of representatives and the secretary of the senate, and shall give to those officers his name, address, the person, association, or corporation, one or more, by whom he is employed, and in whose interest he appears or works as aforesaid. He shall likewise state how much he has been paid, and is to receive, and by whom he is paid, or is to be paid, and how much he is to be paid for expenses, and what expenses are to be included, and set out his contract in full.”

"Any person, before he shall enter into and engage in such practices as heretofore set forth, in connection with federal bureaus, agencies, governmental officials, or employees, shall register with the federal trade commission giving to the federal trade commission the same information as that required to be given to the clerk of the house and secretary of the senate in section 1 of this act.”

"At the end of each three-month period, each person engaged in such practices as aforesaid shall file, either with the federal trade commission or the clerk of the house or the secretary of the senate, as required herein, a detailed report of all moneys received and expended by him during such three-month period in carrying on his work as aforesaid, to whom paid, and for what purpose, and the names of any papers, periodicals, or magazines in which he has caused any articles or editorials to be published.”

The effectiveness of the pointed opposition to the bill by the two professions indicates the value of their coöperative action.

Coöperation of accountants with the bench may not usually be feasible in the same manner, or to the same degree, as between accountants and members of the bar and between their respective professional organizations. Even to this statement, however, there are exceptions. For example, one of the federal judges in New Jersey has availed himself of the assistance of certified public accountants in considering bankruptcy cases before him and in reviewing applications from bankrupts for discharge in proceedings brought under the federal bankruptcy law.

Judge John C. Knox, well known for his services in attempting to eliminate abuses in the field of bankruptcy administration, made the following statements in the course of an address at the
twelfth annual fall conference (October, 1934) of the New York State Society of Certified Public Accountants:

"So important is his (the public accountant's) function in carrying on modern economic life, that he rightfully enjoys a status that is as dignified and outstanding as that of lawyers and members of the medical profession. And as a result, the accountant is charged with commensurate responsibility.

"The power of an accountant for the service of good and evil is no whit less than that possessed by the lawyer and physician. The accountant's nimbleness of mind and his dexterity of hand can reveal truth or they can conceal it. They may also furnish safeguards for the preservation and increment of the nation's wealth; or they may be so used as to impoverish the land.

"I welcome your support. I recognize and applaud the contribution that the accountants of a community have made to the proper administration of bankruptcy, and I commend, too, the interest that you manifest in the subject."

In a case coming before one of the vice-chancellors of New Jersey a few years ago, he wrote an opinion which implied that not only the interests of the estate concerned had been served by the engagement of accountants to deal with complex accounting questions which had arisen, but that the court had been aided thereby.

After setting forth that,

"The master finds and reports that complainants (administrators of the estate) were amply justified in engaging such accountants for the services rendered by them . . . , and that such charges are reasonable, but disallows the items because of his belief that . . . the allowance could not lawfully be made."

the vice-chancellor concluded as follows:

"It is true that under ordinary circumstances the commissions allowed to a trustee . . . are intended to cover the work and expense of keeping his books and preparing his account, and that payments made by the trustees to bookkeepers, accountants or lawyers for performing these services which the trustee is supposed to perform for himself, can not be allowed as items of discharge in his account. Wolfe's case, 34 N. J. Eq. 223. As is said in Kingsland v. Scudder, 36 N. J. Eq. 284, 'If the fiduciary chooses to employ others to do his work he must pay them himself.'

"What, however, is the fiduciary's work? Certainly, work which is beyond the ordinary or reasonably-to-be-expected skill and ability of such a fiduciary can not be deemed his work, and he will be entitled to obtain the skilled services of experts where necessary or advisable, and to have their compensation paid out of
the estate; and indeed would probably be censurable, and perhaps personally liable, if he failed to do so.

"It is on this basis that allowances are made for the services and advice of counsel. Such allowances will not be made where the services of counsel are not reasonably required, as for instance in the making up of the ordinary executor's or administrator's account. It does not take one skilled in legal matters to do that. On the other hand, what would be thought of a fiduciary, a layman entirely unversed in the law, who attempted to carry on himself, unaided by a lawyer, a complicated litigation involving the interests of the estate? Or suppose an ordinary business man appointed a testamentary guardian with directions to educate the ward along certain specialized and technical lines. Naturally the guardian would be allowed reasonable disbursements for the payment of teachers in such subjects. He would not be expected to do the teaching himself or at his own expense.

"There may be, therefore, I take it matters involved in the computation and distribution of income and capital and in the statement and rendering of their accounts, in unusual and complicated cases, which are beyond the reasonable expectation of the skill and ability of the ordinary fiduciary, in which his employment of an expert, a combination of lawyer and accountant trained in such matters, will be not only justifiable but commendable and even necessary, and for whose compensation allowance may and should be made from the estate.

"Such, it seems clear, both from the evidence and the finding of the master who heard the testimony, was the situation in the instant case. The complicated work, the legal questions involved, the necessity for skilled knowledge in the matters of apportionment of dividends between capital and income, of apportionment of subsequent earnings or dividends in stock acquired through stock dividends, of making the proper income-tax returns and payments, and apportioning the same, and the like, all indicate the reasonableness and the propriety of having these things done or supervised by persons skilled along those lines, and that the skill and ability to do these things properly and for the best interests of the estate is not reasonably to be expected of the fiduciary himself.

"It is perhaps within the skill and ability of the average wage earner or salaried man to make up his income-tax return; but, on the other hand, it is a matter of common knowledge that those in charge of large and complicated business organizations require the services of experts in this line, and by utilizing such services save themselves large sums.

"Each case obviously must depend on its own circumstances, and the test must be that of reasonableness. In the present instance the reasonableness of the expenditure and the propriety of allowing it as a charge against the estate seem beyond question, and the exceptions will be sustained. The master's disallowance
and the defendant's argument in support of such disallowance were both obviously based on the belief that under no circumstance could such an allowance legally be made.

"It is, of course, in no wise intended to open the door to unjustifiable claims for allowance in such matters. The burden of proof will always be upon the fiduciary to establish to the satisfaction of the court that such allowance should be made."

When the accountant does a good piece of work, as a witness who aids in bringing out clearly the facts in a complicated accounting case, or by expounding good accounting practice applicable to a given state of facts, or by assisting counsel in conference or in the development and presentation of a case involving accounting questions, he is really cooperating with the court and aiding in the doing of justice.

In conclusion, it may be observed that the most effective form of cooperation between the professions of law and accountancy—that which will produce most enduring results—is the performance by the practitioners in each profession of their duties in the best and most intelligent manner in those engagements which bring them in contact with each other. This will make the younger profession of accountancy better known to the older profession of law and will enable lawyers the better to understand and to utilize the aid of accountants in those many situations in our complex modern life where the lawyer and the accountant need to complement each other in order that their mutual client may be best served.

Cooperation by the appointment of committees representing our respective professional organizations is helpful; meetings of the character of the one arranged for this evening make, I believe, a useful cooperative contribution; and other means of developing the close contacts our professions should have with each other will be found and fostered. Finally, however, nothing will take the place of that mutual understanding of and respect for each other which is engendered by shoulder-to-shoulder work in those day-to-day engagements where both the lawyer and the accountant have a function and service to perform. The hothouse has its value in the field of horticulture, and we appreciate the beautiful plants produced under the stimulating and forcing influences that prevail there, but when it comes to producing a stately and massive oak of long life which evokes our admiration and even affection, it requires time and the influences of the natural life of
the great outdoors and the daily effect of rain and sunshine, the storm and the calm and all the other things that enter into a natural process of development. So with our professions let us look forward to an ever closer coöperation of an abiding character as the result of the work done together in the interest of our common clients.
"A New Competitor of Business"*

BY ROBERT O. BONNELL

I spent yesterday morning in Washington where I heard the administration's Industrial Coöordinator Berry make a plea that business leaders and the representatives of labor, consumers and investors, get together on an industrial program. I am not going to recount what happened, for most of you read it in the papers last night and this morning. A considerable degree of scepticism was apparent on the part of industry which in the early days of the national recovery administration was decidedly coöperative.

But when the whole blue eagle program finally collapsed and was declared unconstitutional, after considerable time, effort and money had been spent, industrial leaders reached the conclusion that they had best attempt to work out their own problems and avoid becoming involved in new moves by the administration which might again result in little but confusion. Indeed business and industry seem to have little enthusiasm for many things the government has done, and there is some justification for that feeling.

A recent report of the Brookings Institute makes it clear that standards of living increase by the creation of more wealth and not by attempting artificially to divide up existing wealth; that an economy of scarcity means less for all; that money is not wealth, but merely a medium of exchange; that artificially stimulated price increases eventually work the greatest hardships upon the laborer and the farmer and tend to lower the standard of living; that large government spending means higher taxes—that higher taxes lead to increased prices with a consequent decrease in real income and real wages; that wealth can be best distributed equally by intensified activities directed toward increased production of wealth by agriculture, business and industry—by giving more for less money, not through the reduction of wages, but by increased efficiency.

However, an examination of our governmental activities indicates that we are following exactly the opposite course. We have been destroying our surpluses, which means the destruction of

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*An address delivered at the annual banquet of the Maryland Association of Certified Public Accountants, Robert Morris Associates and the Association of Bank Auditors, Baltimore, Maryland.
wealth. Schemes have been urged for the specific purpose of artificially dividing the existing wealth. We have attempted to create an economy of scarcity. We treat money as wealth rather than as a medium of exchange. Prices have been artificially stimulated, and this already is working a hardship upon labor. It is also beginning to affect the farmer's sales and will affect adversely the standard of living.

Government has been a profligate spender; taxes are higher and real incomes and real wages are thus being lowered. We have paid people for producing less, thus putting a penalty on efficiency. Furthermore, we have had a trick bookkeeping system which the government would probably condemn as crooked if it were indulged in by the railroads or the utilities or any other group which issued securities to the public.

The federal government has continued to spend twice as much as it expected to take in. Its program of relief has had the effect of steadily increasing the number of those on the relief rolls and the cost of taking care of them since 1933, even though industrial employment has increased 20 per cent. since then, and labor income has greatly improved. But worse than that, it is developing a class of professional charity seekers. Governmentally speaking, we seem to be getting nowhere fast, except further into debt and more confused. It has been well said that the people should support the government, for government can not support the people.

In spite of the unsatisfactory state of affairs in government, there is a good deal of loose talk by politicians about the necessity of cleaning up business, of more regulations and more investigations. By whom is this cleaning up to be done? By whom are these regulations to be drafted? By whom are these investigations to be made?

Are the people to be assigned to these tasks practical, successful and experienced business men who, by their training, ability and character, have demonstrated their capabilities to clean up, regulate and investigate, or are they to be men who have found it more profitable to feed at the public trough; who revel in shouting threadbare platitudes from soap boxes; men who are long on promises, but short on performance; men who in the discharge of their responsibilities have proved to be wasters and wouldn't recognize a truly balanced budget if they saw one; men who talk in terms of a more abundant life while they spend 35
per cent. out of every dollar the American worker and business man can make?

Are these “cleaners up,” these regulators and these investigators to be the men who can conjure up such legislative monstrosities as the potato bill, men who spend their time building model villages in which no one lives, men who buy grandfather clocks with Westminster chimes, pewter plates and maple candle sticks for more government employees to use while they harness the sea at Passamaquoddy, or perhaps those who would use $24,000 public-works-administration funds to make Rye, New York, handball conscious? You can answer these questions and in your answers you will find little promise of anything constructive.

While it is true that in any free country, frauds will be perpetrated in the name of freedom by those in high places as well as in low places, politicians can not escape this indictment. Just as there will always be a few in business who will abuse their liberty, there will be those in government who will abuse their power under any system. Those guilty of fraud, whether they be politicians or business men should be punished, but the lack of moral fibre among a few is no excuse for junking the whole system of American government which has served us well for a hundred and fifty years. Personally, I prefer to take my chances with my average fellow business man rather than to place my trust in the “mine run” of politicians.

Certainly there is little to encourage even the most optimistic to expect any very practical revamping of either our social or economic structures by a government so hopelessly confused in its own policies, and whose extravagance, if continued, will lead straight to bankruptcy.

If the politician really wants to improve the situation in America and really cares to speed recovery, he could do no better than to insist that business men help him clean up the government’s house, that the business men issue regulations under which the business of government would be required to operate and that this be done only after the most thorough investigation has been made of every department of the federal government by the best possible business brains in America. Above all, the politician would, as rapidly as possible, take the government out of competition (whether it be direct or indirect competition) with business, industry, labor and agriculture.
Now let's examine some features of governmental competition. Lewis H. Brown, president of the Johns Mansville Corporation, made an address before the American Bankers Association in New Orleans in which he developed an angle of governmental competition which must not be overlooked.

By and large, business and industry compete for what they consider to be their share of the consumer's dollar. Not so long ago every man considered only those in the same sort of business as his competitors. For instance, one ice man was concerned primarily with the part of the consumer's dollar that other men in the ice business received.

However, as electric and gas refrigeration developed, all ice men became vitally interested in the part of the consumer's dollar that these new competitors received. Consequently, the ice men, who had hitherto been at each other's throats, banded together in an attempt to save for themselves as much of the consumer's dollar as possible. This situation developed in many departments of business, and each in turn recognized that first one competitor after another was cutting into the share of the consumer's dollar it had previously enjoyed.

But gradually business and industry are awaking to the fact that their greatest competitor for the consumer's dollar is the government. At first blush that sounds ridiculous, but let's see how far that competition has gone.

While the national income in 1934 was approximately forty-five billion dollars, local, state and national governments spent fifteen and one-half billion dollars. In other words, government costs last year equalled one-third of our total income. In spite of heavy governmental borrowings, based on the credit of individual citizens (which those citizens must eventually repay through greater taxation), the government took and spent between 20 and 25 per cent. of all that we earned. Furthermore, as our government debts are pyramided, this new competitor of business promises to take an increasing share of the consumer's dollar.

The figures indicate that twenty years ago the total taxes collected by the federal government amounted to only $400,000,000 annually. In other words, it spent about $7 a year per person. With the passage of the sixteenth amendment, the federal income tax furnished the impetus for increased governmental spending. The adoption of that amendment meant surrender by the citizen of a right to the federal government not previously delegated
to it by the constitution,—his right of freedom from direct tax levies. Unlimited spending followed. As a result, from a $7 per capita expenditure in 1915, we shall reach, in federal spending this fiscal year, a new record high of about $70 per capita. This means a 900 per cent. increase in twenty years. That's something to think about.

If we examine the per-capita cost of combined local, state and federal governments, we get little consolation, for in 1915 the combined expenditure was $33.84 per capita, while in 1934 it had increased to $122.50.

Every business man and every industrialist, no matter whether he be large or small, must recognize that government has, in the last 20 years, increased by 700 per cent. the amount it demands of the consumer, which means that the part of the consumer's dollar available to all others is proportionately reduced. We may well ask ourselves what business and industry have done about this new competitor. Have they massed their forces, as trade associations did against other competitors, to try to remedy this situation? Only in a half-hearted way—and there are millions of business men who plead that they are too busy to give thought to government or to take an active part in finding a solution to its multifarious problems.

Grumblings and groanings over hardships imposed upon persons, businesses and industries by taxation or by legislation will get us exactly nowhere. We have chosen men to represent us in all branches of government. If each of us would voice his opinions to those representatives and suggest constructive remedies, we should soon see a marked change in governmental policies. If some of those chosen refuse properly to represent us, then with an aroused and enlightened public interest, others who will do so can be elected to take their places.

The great fault in the past has lain with business and industrial leaders who have left the formation of programs to politicians. We have accepted party platforms on faith, with no attempt to determine training, ability or disposition to "make those promises good."

Business and industry must have a program. They must take a hand in seeing that those who are selected to carry out that program can be reasonably expected to get results—and when I refer to business I include all those who are in business, whether it be the business of growing crops, raising live stock, merchandising dry goods or giving medical, legal or financial advice.
A New Competitor of Business

Any competitor which insists upon having such a large slice of the consumer's dollar as the government does, not only affects the business man and the industrialist, but also vitally affects those who are on the payrolls of business and industry. While it may be true that 12 per cent. of the people in this country must at present look to public relief in one form or another for all or a part of their food, clothes and shelter, it must not be forgotten that the remaining 88 per cent. depend upon business and industry for their livelihood. Any governmental policy or any combination of policies which has a tendency to reduce the natural progress and development of business is striking at the very vitals of the man who earns his living by the sweat of his brow and the skill of his hands and is unduly retarding the recovery movement. Here again let us remember that the best government is the one that governs the least.

And schemes, which by the regulation of hours or of base pay result in the unwarranted increase in wages, in effect take jobs from millions of marginal workers. For obviously, if a business or an industry is to continue to operate it must earn a reasonable return upon its invested capital, or that capital will be dissipated and failure will follow.

If the cost of production, through unreasonably high labor costs, makes it possible to continue to employ only those who are abnormally efficient in order to compete on a price and quality basis, the marginal workers—those who possess only mediocre qualifications—will eventually be dropped from the payrolls by the installation of labor-saving devices made profitable by excessive labor costs.

The motives of those who would raise wages may be entirely praiseworthy. They may sincerely desire to raise the standards of living. On the other hand, it is highly probable that the effect of their efforts will be the opposite.

It would appear, then, that by unwarranted interference in the regulation of hours and wages, government may be gradually, but no less surely, creating a new competitive condition which will eventually throw millions of marginal workers out of jobs. This is another case of the old bromide "All that glitters is not gold."

Let me give you another illustration of how legislation, conceived undoubtedly with the best of intentions, may work in reverse. Before the national recovery administration was declared unconstitutional, rules and regulations were issued covering cer-
tain industries. National recovery administration rules and regulations were urged upon a certain company which employed one hundred and fifty men. The company, hitherto successful, but largely dependent upon the copper smelters to absorb its output, was having an increasingly difficult time in 1931 and 1932. Something had to be done. As a result of a conference between the representatives of the workers and the executives, a plan was adopted under which the absolutely necessary running expenses were to be paid first and the balance of the company's income was split among the workers and executives in proportion to the previous average weekly earnings of all concerned, except that the higher priced executives took a proportionately smaller share. In this manner the plant was kept operating and the men were not forced to go on relief. An experimental crew was put to work and a new product developed, which has not only put the company back on its feet but has given the men a wage scale higher than that previously enjoyed.

Back in 1933, government officers attempted to force this company to install national-recovery-administration wages, arguing that the difference in cost could be made up by increasing the price of the product. Such a move would have destroyed even the limited market the company had left and would have resulted in closing the plant in less than two months. Of course, the company didn't get the blue eagle, but it did keep its men at work and its capital structure largely intact.

There are hundreds of such illustrations. Business men must deal with facts and not with theories. Instead of bettering the conditions of the laboring man in the instance just cited, governmental interference would have destroyed his means of livelihood.

During the last couple of years the government has gone into various types of businesses under one name or another. It has, for instance, entered almost every phase of the banking business —consider the powers given it by broadening the activities of the reconstruction finance corporation, the federal reserve system, the federal deposit insurance corporation, the federal housing administration and the thirty-five distinct agencies in Washington that have something to do with mortgages. The federal government is said to be the world's largest mortgage holder. It now insures the free shares of building and loan associations and even the mortgages themselves. It is practically underwriting real-
estate values throughout the country and no one can tell the extent of its present contingent liabilities.

Most of these government agencies were brought into being to promote recovery. There are those which have served a highly useful purpose, but there are indications that the urge is already being felt to have some of them continue as a permanent part of our governmental structure in competition with private capital, while that capital subsidizes these operations through taxation. Such competition would be, of course, grossly unfair and, if persisted in, will have the effect of deterring private capital initiative, which is so desirable in any recovery movement.

Innumerable instances of governmental competition with businesses could be cited. The Tennessee valley authority is only one of several huge power projects. We wonder why our government wants to compete with public utilities, for we know that about $11,500,000,000 have been invested in utility bonds by the American people, of which the average man has supplied a healthy part through his insurance policies, his deposits in savings banks, the holdings of hospitals, colleges and universities, etc.

We ask ourselves who provided the brains to discover electricity and to develop private enterprise? Who furnished the money and the talent to build and manage public utilities—the politician or the ambitious, hard working, intelligent free citizen? We remember with no little discomfort, our experience with government operated railroads. We want no more of it.

All of us are concerned by the destruction of our surpluses which means the destruction of wealth. Historically, as I've already suggested, prosperity is linked with increased—not decreased—production. There can be no real prosperity in an artificial economy of scarcity. There is a bad reaction from any attempt eventually to circumvent the natural laws of supply and demand.

As a result of the administration's hog-killing raid to reduce surpluses and thereby raise the price of pork, it is reported that pork and lard consumption has decreased 28 per cent. and that the American housewife is serving less pork than in any year since 1917.

The ruthless slaughtering of cattle and hogs and the plowing up of cotton and wheat has laid further burdens upon the people, who, through the processing taxes, are being compelled to pay for this ruthless destruction. Meanwhile, during the first three months of 1935, twenty-four million square yards of cotton cloth
were imported, while thousands of workers in the cotton mills of this country were idle. Ten times as many pounds of cotton seed cake and meal were imported in March, 1935, as were imported in March, 1934.

We imported 600 per cent. more butter the first three months of 1935 than in the first three months of 1934. We imported 140 times as much corn during the same period. For the first three months of 1935 we imported 24 million pounds of fresh meat and seven million pounds of canned meat. We have thus provided work and wages for foreign farmers and labor to make up the deficits we wilfully created. The people are being taxed, not only for the increased cost of the necessities of life, but to pay for this wanton destruction of our crops and animals. Higher food prices resulting from the agricultural adjustment administration experiment brings forth the following significant statement: "Increasing competition, accompanied by consumer resistance to current food prices, is having a depressing influence on the entire grocery line." Are these the results the government sought? They are the results predicted by the Brookings Institute.

Here, then, is an example of another type of competition stimulated by a governmental attempt artificially to circumvent the natural laws of supply and demand.

These schemes put the government further into business, when its constant endeavor should be to get out, and keep out, of business. All its attempts to run a business have resulted in increasing deficits, which must be paid by those with whom it competes. It has yet to demonstrate that it can economically run the job it was designed to do. It already has plenty to keep it busy without looking for more trouble and expense.

We have examined several types of government competition—direct competition by entering upon business ventures, competition for a larger and larger share of the consumer's dollar—a competitive condition created, which deprives the marginal worker of his job; regulations and legislation which would make profitable operation impossible, thus throwing labor on relief; commodity-price manipulation, which gives the competing foreign agriculturist and laborer a new foothold in our domestic market and reduces industrial activity and the volume of American sales.

The extraordinary delegation of power to the central government which has made these competitive movements possible would never have been tolerated except in the name of emergency
A New Competitor of Business

and recovery. We were apparently willing to surrender a very substantial portion of our freedom in the hope of getting some relief from the knotty problems presented by the depression.

This surrender of a part of our freedom reminds me of an address delivered by our own Dr. Harris Kirk in London last summer. It contained much that we can profitably think over. It was entitled "When God Says No!" and revolved around the story of the prodigal son, who, after having wasted his substance, returned to his father and suggested that he be permitted to become one of his father's servants. In this request the prodigal son was actuated by the desire to be relieved of his individual responsibility and was willing to sacrifice his freedom in order to have a small measure of what he thought would be security in his father's household. By abusing his freedom, he had lost his substance, which led to suffering. Rather than face the responsibilities of his position, he was willing to surrender his freedom and become a servant.

It seems to me that there is a lesson in that thought for many Americans. It is probably true that a great many of us abused our freedom. Many of us lost much of our substance, and suffering followed. Many have been looking for an easy way out.

Some seem willing, for the sake of a temporary feeling of security, to sacrifice freedom, our dearest possession. We appear to be willing to forego our freedom in order to realize our immediate desire. To a certain state of mind this is always an attractive alternative to the necessity "of facing the austere conditions of life." While that state of mind prevails, "servitude and ease walk together." It has been well said that "truth is an uneasy companion to a lazy mind." The politician, taking advantage of that state of mind, offers an exchange of freedom for the ease of a servant.

Individual liberty, the political principle which prompted the founding of this nation, is imperilled today by the "sick fatigue" of our present world. The traditional American's demand for progress has always dominated our political thinking. We have been imbued, and most of us still are, with the idea that the individual man can only reach the highest form of development under the "free institutions of a truly democratic state."

We have watched with the utmost trepidation the abandonment, in part at least, of this faith in free institutions by some European countries. This retreat can probably be explained by the
willingness of a great many prodigal sons who had wasted their substance to become the servants of a master they hoped would relieve them of the necessity of finding a practical solution to the multifarious economic and social problems arising out of the world war and its aftermath. These prodigal sons are unwilling to make the temporary sacrifice necessary to find the real solution to these problems. What most of us believe they bought was a temporary peace of mind at the price of their individual freedom. Is that what you and I want? Of course not.

Americans have built on the theory that the citizen could be expected, if permitted his freedom, to be master of his own destiny. There is, however, among us now a school of thought which would have us believe that nothing can be expected of the individual man if left to his own devices. There are those who would have us believe that they alone know what is best for us and that we must, therefore, be helped by them.

In his talk, Dr. Kirk referred to a species of caterpillar fittingly known as the "procession caterpillar." These insects travel in great companies. They move in single file and in long lines. The feelers of each caterpillar rest upon the hind quarters of the one in front. Here individuality is completely submerged and any creature that falls out of line is hopelessly lost. A naturalist when studying such a procession turned the leader around until his feelers rested upon the hind quarters of the last caterpillar in the line. Immediately the whole procession began to travel round and round in a great circle until the individual insects finally died. Here we have an excellent illustration of perfect regimentation.

It might be well for us to give serious thought to its significance.

With so many organizations of our citizens going around and around in circles, is it any wonder that we are not solving as intelligently and as promptly as we might the problems which are traceable in no small degree to the regimentation indulged in during the world war period? That regimentation is one of the best examples of the futility of the procession-caterpillar arrangement. It was to have made the world safe for democracy. Did it? It wasted lives, destroyed wealth, brought untold misery and threw the world economic system into almost complete chaos.

Our hope lies, not in regimentation, but in the realization that in freedom we have a priceless heritage not to be bartered away for temporary relief from facing the actualities which must be
A New Competitor of Business

dealt with practically before any permanent stability can be established.

Our peace and security will be assured by the perpetuation of a system which develops in men the passion to be free—a system which recognizes their right to develop as individuals. It was just such a system which developed our Washingtons, our Jeffersons, our Lincolns and our Cleveland.

We can not expect to maintain our freedom without accepting our share of responsibility. Too many of us have been willing to "let George do it," but George hasn't done it. It is time that every business man stop grumbling and get to work. He must study his government; he must take a hand in solving its problems. He must refuse to become a procession caterpillar, for he can never be sure, as long as he follows blindly, that the whole procession is not moving in circles.

Let's do a little thinking and acting on our own. We are concerned about a four billion dollar deficit this fiscal year, added to the deficits for four previous years. We are concerned about a federal debt of 30½ billions and a total government debt in this country of 50 billions.

Perhaps it is true that no one is going to shoot Santa Claus just before Christmas, but every person in the United States over the age of twelve knows who pays the bills for the jolly and smiling fellow who distributes the gifts. The American taxpayer is the real Santa Claus. The government merely wears the trick red suit and the funny white whiskers and does the smiling.
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 II

November 15, 1935, 1:30 P. M. to 6:30 P. M.

Solve problems 1 to 5 and two of the four problems 6 to 9.

No. 1 (30 points):

The following is a summary of an analysis of the "investment in subsidiary companies" account in the ledger of the "P" Company as at June 30, 1935:

<table>
<thead>
<tr>
<th>Company</th>
<th>Class of stock</th>
<th>Number of shares issued and outstanding</th>
<th>Number of shares owned</th>
<th>Amount at which shares are carried</th>
<th>Last dividend paid or declared for the period ended</th>
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</thead>
<tbody>
<tr>
<td>&quot;A&quot; Company</td>
<td>7% first preferred</td>
<td>5,000</td>
<td>4,000</td>
<td>$200,000</td>
<td>June 30, 1932</td>
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<tr>
<td></td>
<td>7% second preferred</td>
<td>5,000</td>
<td>4,900</td>
<td>245,000</td>
<td>June 30, 1932</td>
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<tr>
<td></td>
<td>Common</td>
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<td>9,990</td>
<td>100,000</td>
<td>Sept. 30, 1929</td>
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<td>7% cumulative preferred</td>
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<td>800,000</td>
<td>June 30, 1933</td>
</tr>
<tr>
<td></td>
<td>Common</td>
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<td>10,000</td>
<td>1,000,000</td>
<td>June 30, 1933</td>
</tr>
<tr>
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<td>450,000</td>
<td>Sept. 30, 1934</td>
</tr>
<tr>
<td></td>
<td>Common</td>
<td>5,000</td>
<td>5,000</td>
<td>500,000</td>
<td>Sept. 30, 1934</td>
</tr>
</tbody>
</table>

$3,295,000

The certificate of incorporation of the "A" Company stipulates that in the event of dissolution the 7% first preferred stock shall be entitled to $75 per share before any distribution is made to holders of any other class of stock, and no more. It further provides that after $75 per share has been distributed to the holders of the 7% first preferred stock the holders of the 7% second preferred stock shall be entitled to receive $62.50 per share before any distribution is made to the holders of the common stock, and no more. The balance is to be distributed to the holders of the common stock.

The certificate of incorporation of the "B" Company stipulates that, in the event of liquidation or winding up, the 7% cumulative preferred stock shall be entitled to $105.00, plus all dividends, before any distribution is made to the holders of the common stock, and no more. The balance is to be distributed to the holders of the common stock.

The certificate of incorporation of the "C" Company stipulates that after providing for all unpaid dividends on the 6% cumulative preferred stock the holders of the preferred and common stocks shall, in the event of dissolution, liquidation or winding up, be entitled, share and share alike, to all remaining assets.

A condensed summary of the assets and liabilities of the several companies as at June 30, 1935, follows.
<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$450,000.00</td>
<td>$1,000,000.00</td>
<td>$120,000.00</td>
<td>$150,000.00</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>800 shares of &quot;D&quot; Company common.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>$3,295,000.00</td>
<td>$2,950,000.00</td>
<td>$2,250,000.00</td>
<td>$2,950,000.00</td>
</tr>
<tr>
<td>Fixed assets, less depreciation</td>
<td>$150,000.00</td>
<td>$250,000.00</td>
<td>$17,000.00</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Other assets</td>
<td>$17,000.00</td>
<td>$25,000.00</td>
<td>$9,500.00</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Total assets</td>
<td>$710,000.00</td>
<td>$2,365,000.00</td>
<td>$1,540,000.00</td>
<td>$3,420,000.00</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$125,000.00</td>
<td>$225,000.00</td>
<td>$32,500.00</td>
<td>$350,000.00</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$710,000.00</td>
<td>$2,365,000.00</td>
<td>$1,540,000.00</td>
<td>$3,420,000.00</td>
</tr>
</tbody>
</table>

Prepare a schedule of the minority interest, assuming liquidation at book value.
**Solution:**

The problem requires that the schedule of the minority interest be computed on a liquidating basis; hence the stipulations of the certificates of incorporation relative to the liquidating provisions of the various classes of stock must be considered. Furthermore, it must be assumed that the book values of the assets and liabilities of the companies are the liquidating values, as no information is given in the problem to give effect to any adjustments in these values.

The schedule should be started with the "lowest" company in the consolidation, because, it will be noted, Company A holds stock in Company B, and Company C holds stock in Company D.

Company P and its subsidiaries, Companies A, B, C and D

Schedule of minority interest

June 30, 1935

<table>
<thead>
<tr>
<th>Company D:</th>
<th>Minority Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book value:</td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Surplus</td>
<td>47,250.00</td>
</tr>
<tr>
<td>Total</td>
<td>$147,250.00</td>
</tr>
<tr>
<td>Less: treasury stock</td>
<td>6,250.00</td>
</tr>
<tr>
<td>Total book value</td>
<td>$141,000.00</td>
</tr>
<tr>
<td>Per share value (9,400 shares)</td>
<td>$15.00</td>
</tr>
<tr>
<td>Company C's interest (9,000 shares)</td>
<td>$135,000.00</td>
</tr>
<tr>
<td>Minority interest (400 shares)</td>
<td>$6,000.00</td>
</tr>
</tbody>
</table>

| Company C: | |
| Book value: | |
| 6% cumulative preferred stock | $500,000.00 |
| Common stock | 500,000.00 |
| Surplus | 300,000.00 |
| Increase in equity in Company D: | |
| Value (per above) | $135,000.00 |
| Book value | 112,500.00 |
| Total book value | $1,322,500.00 |

Distributed, as follows:

| | 6% Cumulative preferred | Common |
| Par (or stated) value | $500,000.00 | $500,000.00 |
| Accrued dividend since September 30, 1934 (6% for 9 months) | 22,500.00 | |
| Remaining surplus (share and share alike) | 150,000.00 | 150,000.00 |
| Totals | $672,500.00 | $650,000.00 |
| Per share value | $134.50 | $130.00 |
### Students' Department

#### 6% Cumulative Preferred:
- **Company P’s interest (4,500 shares)**: $605,250.00
- **Minority interest (500 shares)**: $67,250.00

#### Common:
- **Company P’s interest (5,000 shares)**: $650,000.00

#### Company B:
- **Book Value**: $1,000,000.00
  - **7% Cumulative Preferred Stock**: $1,000,000.00
  - **Common Stock**: $1,000,000.00
  - **Deficit**: $100,000.00
  - **Total Book Value**: $1,900,000.00

#### Distributed as follows:

<table>
<thead>
<tr>
<th></th>
<th>7% Cumulative Preferred</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par (or stated value)</td>
<td>$1,000,000.00</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Premium, in liquidation ($5 per share)</td>
<td>$50,000.00</td>
<td>$50,000.00</td>
</tr>
<tr>
<td>Deficit</td>
<td>$100,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$1,050,000.00</strong></td>
<td><strong>$850,000.00</strong></td>
</tr>
<tr>
<td><strong>Per Share Value</strong></td>
<td><strong>$105.00</strong></td>
<td><strong>$85.00</strong></td>
</tr>
</tbody>
</table>

#### 7% Cumulative Preferred:
- **Company P’s interest (8,000 shares)**: $840,000.00
- **Company A’s interest (1,000 shares)**: $105,000.00
- **Minority interest (1,000 shares)**: $105,000.00

#### Common:
- **Company P’s interest (10,000 shares)**: $850,000.00

#### Company A:
- **Book Value**:
  - **7% First Preferred Stock**: $250,000.00
  - **7% Second Preferred Stock**: $250,000.00
  - **Common Stock**: $100,000.00
  - **Surplus**: $25,000.00
  - **Increase in Equity in Company B (1,000 shares preferred)**:
    - **Value (per above)**: $105,000.00
    - **Book Value**: $50,500.00
  - **Total Book Value**: $679,500.00

**Note:** The certificate of incorporation provides that after the first preferred stock has received $75 in liquidation, the "holders of the 7% second preferred stock shall be entitled to receive $62.50 per share before any distribution is made to the holders of the common stock." After the first preferred has received its $75 per share in liquidation, only $50.00 per share is available to the second preferred stock holders; hence nothing is left for the holders of the common stock.
Distributed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Minority Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total book value (per above)</td>
<td>$ 679,500.00</td>
</tr>
<tr>
<td>Applicable to 7% first preferred (5,000 shares at $75 each)</td>
<td>375,000.00</td>
</tr>
<tr>
<td>Remainder applicable to 7% second preferred</td>
<td>$ 304,500.00</td>
</tr>
<tr>
<td>Per share value (second preferred)</td>
<td>$ 60.90</td>
</tr>
<tr>
<td>7% first preferred:</td>
<td></td>
</tr>
<tr>
<td>Company P's interest (4,000 shares)</td>
<td>$ 300,000.00</td>
</tr>
<tr>
<td>Minority interest (1,000 shares)</td>
<td>$ 75,000.00</td>
</tr>
<tr>
<td>7% second preferred:</td>
<td></td>
</tr>
<tr>
<td>Company P's interest (4,900 shares)</td>
<td>$ 298,410.00</td>
</tr>
<tr>
<td>Minority interest (100 shares)</td>
<td>$ 6,090.00</td>
</tr>
<tr>
<td>Common: (no value)</td>
<td></td>
</tr>
<tr>
<td>Total minority interest—Company A</td>
<td>$ 81,090.00</td>
</tr>
</tbody>
</table>

Company P and its subsidiaries, Companies A, B, C, and D

Summary of minority interest

June 30, 1935

<table>
<thead>
<tr>
<th>Company</th>
<th>Minority Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>$ 81,090.00</td>
</tr>
<tr>
<td>Company B</td>
<td>105,000.00</td>
</tr>
<tr>
<td>Company C</td>
<td>67,250.00</td>
</tr>
<tr>
<td>Company D</td>
<td>6,000.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$259,340.00</strong></td>
</tr>
</tbody>
</table>

**Note.**—The certificate of incorporation of Company B provides that the 7% cumulative preferred stock shall be "entitled to $105, plus all dividends, before any distribution is made to the holders of the common stock, and no more."

If Company B had a surplus account at this date, no question would arise: the preferred stockholders would be entitled to the premium of $5 per share, plus the unpaid cumulative dividends. However, the company has a deficit of $100,000 at the balance-sheet date, and while there can be no question but that the preferred stockholders should receive the premium of $5 per share, there is a very definite question regarding the unpaid cumulative dividends. Conyngton in his *Business Law* volume I (Ronald Press) says, on page 406, "It is often provided that in case of dissolution preferred stock shall be satisfied out of any assets of the company before the common stock receives anything. If this provision is not made, either by statute or by charter, the preferred stock in any liquidation of the corporation will first receive any dividends then due, but thereafter will fare the same as common stock." And in the following paragraph "Preferred dividends may be paid only from profits. If there are no profits, or if the profits are needed for purposes of the business, the dividends to preferred stock are either passed entirely or cumulated until profits are made." (In this case, we do not know whether the company ever had any profits). Finney, in his *Principles of Accounting* (Prentice Hall, Inc.) volume I (1934)
Students' Department

says on page 59, "dividends in arrears are not payable at liquidation unless the stock is cumulative and a surplus exists sufficient to cover the dividends in arrears."

The foregoing solution has been solved on the basis that the preferred stock of Company B was to receive the premium of $5 only, as there were no profits or surplus balances from which to declare any dividends at the balance-sheet date.

However, it is possible that the examiners intended that the stipulation in the certificate of incorporation be interpreted as "entitled to $105, plus an amount equal to the amount of the unpaid cumulative dividends." This interpretation seems a little far-fetched, but probably the examiners would give some credit to a solution which determined the minority interest of Companies B and A as follows:

Company B:

<table>
<thead>
<tr>
<th>Book value</th>
<th>Minority interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>7% cumulative preferred stock</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,000,000.00</td>
</tr>
<tr>
<td>Deficit</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Total book value</td>
<td>$1,900,000.00</td>
</tr>
</tbody>
</table>

Distributed as follows:

<table>
<thead>
<tr>
<th>Par (or stated) value</th>
<th>7% Cumulative preferred</th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium, in liquidation</td>
<td>$1,000,000.00</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Unpaid cumulative dividends (2 years at 7%)</td>
<td>140,000.00</td>
<td>140,000.00</td>
</tr>
<tr>
<td>Deficit</td>
<td>100,000.00</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$1,190,000.00</td>
<td>$710,000.00</td>
</tr>
</tbody>
</table>

Per share value:

| 7% cumulative preferred | $119.00 | $71.00 |

7% cumulative preferred:

| Company P’s interest (8,000 shares) | $952,000.00 |
| Company A’s interest (1,000 shares) | $119,000.00 |
| Minority interest (1,000 shares) | $119,000.00 |

Common:

| Company P’s interest (10,000 shares) | $710,000.00 |

Company A:

<table>
<thead>
<tr>
<th>Book value</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>7% first preferred stock</td>
<td>$250,000.00</td>
</tr>
<tr>
<td>7% second preferred stock</td>
<td>250,000.00</td>
</tr>
<tr>
<td>Common stock</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Surplus</td>
<td>25,000.00</td>
</tr>
<tr>
<td>Increase in equity in Company B (1,000 shares preferred):</td>
<td></td>
</tr>
<tr>
<td>Value (per above)</td>
<td>$119,000.00</td>
</tr>
<tr>
<td>Book value</td>
<td>50,500.00</td>
</tr>
<tr>
<td>Total book value</td>
<td>$693,500.00</td>
</tr>
</tbody>
</table>

231
### The Journal of Accountancy

<table>
<thead>
<tr>
<th>Minority Total Interest as Distributed</th>
<th>Total</th>
<th>Per share</th>
<th>Minority interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>7% first preferred stock (5,000 shares at $75.00)</td>
<td>$375,000.00</td>
<td>$75.00</td>
<td></td>
</tr>
<tr>
<td>7% second preferred stock (5,000 shares at $62.50)</td>
<td>$312,500.00</td>
<td>$62.50</td>
<td></td>
</tr>
<tr>
<td>Common—(remainder) (1,000 shares)</td>
<td>$6,000.00</td>
<td>$.60</td>
<td></td>
</tr>
<tr>
<td>7% first preferred: Company P's interest (4,000 shares)</td>
<td>$300,000.00</td>
<td></td>
<td>$75,000.00</td>
</tr>
<tr>
<td>Minority interest (1,000 shares)</td>
<td>$75,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7% second preferred: Company P's interest (4,900 shares)</td>
<td>$306,250.00</td>
<td></td>
<td>6,250.00</td>
</tr>
<tr>
<td>Minority interest (100 shares)...</td>
<td></td>
<td>6,250.00</td>
<td></td>
</tr>
<tr>
<td>Common: Company P's interest (9,990 shares)</td>
<td>$5,994.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minority interest (10 shares)...</td>
<td></td>
<td>6.00</td>
<td></td>
</tr>
<tr>
<td>Total minority interest—Company A</td>
<td>$81,256.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Company P and its subsidiaries, Companies A, B, C, and D

Summary of minority interest
June 30, 1935

<table>
<thead>
<tr>
<th>Company</th>
<th>Minority Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$81,256.00</td>
</tr>
<tr>
<td>B</td>
<td>119,000.00</td>
</tr>
<tr>
<td>C</td>
<td>67,250.00</td>
</tr>
<tr>
<td>D</td>
<td>6,000.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$273,506.00</strong></td>
</tr>
</tbody>
</table>

No. 2 (20 points):
The Clark Manufacturing Company is being operated by a committee of its creditors and you are called in to prepare financial statements for information of the creditors. Your examination reveals the following:

1. After the creditors' committee had taken charge, but before the date of your examination, a fire had occurred causing an estimated damage of $80,000, made up as follows:

   - Machinery and equipment (Book value less depreciation) $50,000.00
   - Inventories 20,000.00
   - Customers' merchandise on hand for work to be done thereon 10,000.00

   **Total** $80,000.00
Students' Department

(The building occupied was leased and not owned)
The company had accepted from the insurance companies $57,080 in full settlement for the loss, and this amount was still on deposit at the date of your examination. The cost of clearing the debris and obtaining the equipment considered necessary would be $47,250.

2. There is $130,112 in accounts and notes payable to creditors, parties to an agreement whereby each creditor accepted a note of the corporation, due October 31, 1937 and bearing interest at 5% per annum. The notes are secured by mortgage on all plant property and by all the issued capital stock. The latter is held in escrow. There will be $13,348 interest accrued on the notes at maturity.

3. Expenses have accrued to the amount of $1,532.

4. There is due to the president $30,000 for salary and cash advances for which the corporation gave him a demand note. A part of the agreement with the creditors was a covenant by the president to take capital stock for this note at par. The president could not surrender the note, however, because he had used it as collateral to secure a personal loan. The stock had therefore not yet been issued.

5. There is a corporation note dated February 1, 1931, payable on demand to the widow of the former treasurer, for $6,900. She has agreed to subrogate her claims to those of the other creditors.

6. The liabilities incurred since the creditors entered into the agreement aggregate $15,699.

7. There are $17,400 notes payable for equipment purchased prior to the creditors' agreement, due in monthly instalments of $2,175 each and secured by chattel mortgage on the equipment.

8. Balances aggregating $3,066 are due employees under an arrangement whereby they received 90% of their earnings in cash and 10% in scrip payable October 31, 1937.

9. A deficit of $178,032 existed at the date of the creditors' agreement. The subsequent loss from operations is $8,942 before adjustment of the fire loss.

10. The authorized capital stock is 150,000 shares of $10 each, of which 50,000 shares are issued and outstanding and placed in escrow for the benefit of creditors. Of the unissued 100,000 shares 5,350 were subscribed in 1928 but the subscriptions were never paid. They are of doubtful status and are given to the creditors' attorney for collection.

From the foregoing data prepare the liabilities side of the balance-sheet as you would submit it to your client, together with footnotes to the balance-sheet which in your opinion are necessary for a clear understanding of the corporation's financial position.

Solution:

The Clark Manufacturing Company
Balance-sheet (liabilities side)
Date

Liabilities:

Accrued Expenses ........................................ $ 1,532.00
Due to employees ($306.60 payable in scrip due October 31, 1937) ................. 3,066.00
Due to customers' for merchandise destroyed by fire .................................. 10,000.00
Accounts payable (incurred under the management of creditors' committee) .......... 15,699.00

233
Notes payable—secured by a mortgage on all plant property and proceeds of fire loss on machinery and equipment and by all the issued capital stock (there will be $13,348 interest accrued on these notes at maturity, October 31, 1937) ...................... $130,112.00

Chattel mortgage equipment notes (due in monthly instalments of $2,175 each) .......... 17,400.00

Demand notes payable to president (payable in capital stock upon surrender of note which is now pledged as collateral to secure a personal loan) ....................... 30,000.00

Demand note payable to Mrs. Blank (subrogated to claims to other creditors) ............. 6,900.00 $214,709.00

Net worth:

Capital stock—of a par value of $10 each:

Authorized .... 150,000 shares $1,500,000.00

Less: unsubscribed .......... 94,650 shares $946,500.00

Total subscribed 55,350 shares $553,500.00

Less: subscriptions unpaid 5,350 shares 53,500.00

Issued and outstanding, and placed in escrow for the benefit of creditors .... 50,000 shares $500,000.00

Deficit:

Balance at date of creditors' agreement .... $178,032.00

Fire loss:

Estimated damage ... $80,000.00

Insurance recovery .... 57,080.00 22,920.00

Loss from operations ........ 8,942.00 209,894.00 290,106.00

Total liabilities and net worth .............. $504,815.00

Notes.—No provision has been made for accrued interest at the balance-sheet date on the notes payable to creditors, nor the demand notes payable to the president or Mrs. Blank. (The problem does not give the dates of issuance of the notes, or the date of the balance-sheet.)
The unpaid subscriptions to capital stock (5,350 shares amounting to $53,500) are of doubtful collectibility.

Assumptions:

It is assumed that:
The Clark Manufacturing Co. is liable to its customers for their merchandise while in its possession.
The accrued expenses ($1,532) and the amount due to employees ($3,066) were deducted in determining the loss from operations of $8,942.
Book Review


In the preface to Analyzing Financial Statements it is stated that it is a complete revision of the 1925 edition, but the author has not, apparently, paid very much attention to what has happened in the last five or six years. Certainly in a revision of a book on financial statements made in 1934, where the original edition was published in 1925, it would not be unreasonable to expect some discussion of the problems that almost every credit grantor and accountant must face which have resulted from changed conditions both in this country and abroad in the last five years.

Some of these problems, none of which are discussed in the book, are: the effect of the devaluation of the dollar on the relation between bonds and debentures and equity securities; the position of importing houses where commodities must be purchased in a world market on a gold basis or the position of manufacturers or producers who must sell at gold prices in a world market; the necessity for a credit grantor to be certain that foreign-exchange commitments are covered and that inventories are properly hedged; the effect of various methods of inventory valuation, such as, “last-in, first-out” or normal stock methods; the effect of foreign-exchange restrictions particularly with “blocked” currencies; and the effect on the sufficiency of depreciation reserve of dollar devaluation particularly where machinery to be replaced is manufactured abroad.

These are only a few of the vexing problems which almost anyone who is responsible for statement analysis of concerns of any importance meets from day to day. Most of them were not of great importance five or six years ago, and it is somewhat disappointing to see these things overlooked in a book which is intended to be used as a guide to credit grantors in their analysis of financial statements.

It is not fair to criticize a book for not doing something other than that which it purports to do, but when the average reader is lead to expect a fairly complete treatment and finds points such as the foregoing neglected it is, perhaps, a fair criticism to state that important phases of the subject are not covered.

What is in the book is generally true and generally useful but would probably be of more value to a student or to a credit man in a small bank or industrial company than it would be to a trained accountant or a credit man of fairly wide experience. To put it briefly, a credit man might derive considerable benefit from reading this book if he realized that it was a detailed presentation of conventional methods and their application to small or medium-sized companies where no very special or difficult problems existed. If the credit man thought he could apply the methods laid down in this book to the analysis of a large and highly organized corporation, especially if any of its operations were in foreign countries, he might find himself in some difficulty.

Maurice E. Peloubet.

236
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Cost Accounting

BANKS AND BANKING

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Buildings

Oils
Beveridge, John W. Depletion of Oil and Gas Properties; Principles of Depletion Allowances for Determining Taxable Income. TAX MAGAZINE, February 1936, p. 67–70.
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Accounting
Uniform Methods and Systems

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Accounting

HOLDING COMPANIES
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238
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STOCK EXCHANGES
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International double

TAXATION, GREAT BRITAIN
Corporations

TAXATION, NEW YORK CITY

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239

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