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Students' Department

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Students' Department

EDITED BY SEYMOUR WALTON
(ASSISTED BY H. A. FINNEY)

STOCK WITH NO PAR VALUE

There are four expressions used in regard to the capital stock of a corporation with reference to its value per share:

(a) Face value, which is the amount shown on the face of the stock certificate. This is also called the par value of the stock. It is usually $100.00 a share, but may be any amount from one dollar up to one thousand dollars.

(b) Book value, or the value which is shown by the books. In ascertaining this value all the items on the balance-sheet are taken at their worth as they are listed. As the company belongs to the owners of the capital stock, the value of the total stock is manifestly the excess of the assets over the liabilities—in other words the net worth of the business. Since this excess is represented by the amount of the capital stock plus the accumulated profits, or surplus, the book value of each share is found by dividing the sum of the capital stock and surplus by the number of shares outstanding. If the company has made net losses instead of profits, the number of shares must be divided into the amount of the capital stock minus the deficit. The book value of each share is the amount the stockholders would receive for each share held by them if the assets could be realized at the values shown on the balance-sheet and if there were no more liabilities than were therein expressed.

(c) Real value. As the book value is ascertained from the balance-sheet, the real value is determined by a statement of affairs in which the assets are valued at the amounts which they may be expected to realize, without any regard to the values placed on them on the books. If the net free assets are in excess of the total unsecured liabilities, the amount of this excess divided by the number of shares will express the real value of each share. Of course, it must be remembered that the term "real" is relative only, being based on the opinion of those best calculated to judge the actual value of the assets. The true real value can be ascertained only by liquidating the company so that the net worth will be represented by actual cash.

(d) Market value is that for which the stock will sell. This may be different from any of the other values. While it is based primarily on the estimate of investors as to its real value, it is largely affected by the earning capacity of the company. If the business of a company is prosperous and is likely to continue to be so, an investor will often pay much more than the real value for its shares on account of the large returns he expects to receive on his investment in the form of dividends. On the

other hand if a company is making little or no profits, the market value of the stock is likely to be low, although its assets may be undoubtedly good, because an investor does not care to buy stock which will not yield him an income.

In the last analysis of the matter a share of stock represents an undivided interest in the net worth of the company proportionate to the number of shares issued. The true value is not necessarily represented by the number of dollars which appear on the stock certificate. In fact the value on the face of the certificate is seldom any criterion of the true value. So accustomed have people become, however, to considering that a stock certificate calling for ten shares of stock of one hundred dollars each really represents one thousand dollars, that it is difficult for them to realize that such a certificate in a company whose total capital stock is one hundred thousand dollars really represents an undivided one per cent. of the net worth of the company, whatever that may be.

A number of years ago, John Grant Dater, speaking of the report of the Railways Securities Commission, said:

"Most of the evils of which investors and the public complain, according to the commission, have grown out of the attempt to give to stock a face value in terms of money. That is, because a certificate bears on its face words or characters representing one hundred dollars, people persist in regarding it as the equivalent of such a value, whereas the true value may be something wholly different, and may range far above or far below the indicated figures.

"The commission would remove the dollar mark entirely from the face of a share of stock, making these certificates of interest in the property. Such certificates, it points out, would represent the true value of a property at all times more nearly than under the present system.

"To illustrate: why should a property of problematical worth be capitalized, let us say, at twenty-five million dollars, represented by two hundred and fifty thousand shares of one hundred dollars par, with the shares selling in the market at ten dollars, or some such price? The figures on the face are not representative of true value. Would it not be better to issue against such property two hundred and fifty thousand certificates of interest which would fetch their worth in the market at all times?

"Nominal figures of capitalization do not make a property worth more or less, but excessive nominal capitalization, when it is mistaken or confused with true value, works a deception upon investors and the public. It leads to the charge, when the railways want to raise rates, that they are doing so to maintain dividends on watered stocks. It has also proved a real detriment to many corporations in attempting to secure needed funds for development."

Undoubtedly the original idea in forming a corporation was that the capitalization should represent actual value. It is pertinent to inquire why there was not adherance to that idea. The first deviation from it was including among the assets fictitious values ascribed to such things as patents, franchises or goodwill, although on the face of it this was not a deviation since the capital purported to represent value of some kind, and a certificate of interest would not differ in value from a certificate for shares of stock. The practice that causes the most mischief is that of issuing stock at a discount, whether it is original stock or treasury stock. It would seem that if it were desired to raise $200,000 with which to

develop a mine the logical procedure would be to issue 200,000 shares at one dollar each and to sell them at par. Why does the company think it necessary to issue two million shares of a par of one dollar and to sell them at prices ranging perhaps from five cents to twenty-five cents each?

One reason is found in the universal love for a bargain. This is generally considered to be a characteristic of members of the gentler sex, but it is by no means confined to them. To many men as well as women the temptation to acquire one thousand dollars of stock for fifty or one hundred dollars is irresistible. Although many of them really know better, they cannot rid themselves of the idea that a nicely engraved certificate calling for one thousand dollars is actually one thousand dollars. Therefore vastly greater amounts of money can be realized from the sale of bargain stock than could be obtained by selling the stock on the basis of par.

Arthur Train makes Mr. Tutt say "There are two things that women seem to like better than anything else in the world—babies and stock certificates." He could easily have added a third—bargains, and could have stated that when a stock certificate and a bargain are combined in one the attraction is irresistible, and he need not have confined the remark to women.

Another reason for the practice is the ease with which a substantial increase can be made in the price at which stock is being sold by the promoters by what is apparently a trivial increase in the quotation. On stock with a par of one dollar, five cents is only five per cent., and five per cent. is a very small proportion to add to the price of the stock. But if the stock has been selling at ten cents a share an addition of five cents is really an increase of fifty per cent. The shrewd promoter takes advantage of this difference to urge immediate purchase when the stock is selling at ten cents by stating that the price is soon to be advanced fifty per cent., but when the stock has been advanced he consoles a new customer by calling the advance only five per cent.

Still another reason is that it is far easier to sell stock at a discount than at a premium when the time comes to unload the promotion stock. That is, when the project has become a sufficient success apparently to justify the belief that it will be a permanently paying proposition, it is easier to sell the stock which has been issued on the basis of ten cents at 75 per cent. of its face than it would be to dispose of full paid stock at 750 per cent. Yet in actual money it amounts to the same thing. If the capitalization has been for two million shares at a par of one dollar and the promoter has donated half of it to be sold at ten cents a share, he can offer his own stock when the time comes at the bargain price of seventy-five cents a share. If the company had been capitalized with two hundred thousand shares, none to be sold at less than par, he would be obliged to ask seven dollars and fifty cents a share to realize the same amount. Where it might be easy to sell one thousand shares for seven hundred and fifty dollars, it would be difficult to sell one hundred shares for the

same seven hundred and fifty dollars. It is useless to say that the purchaser gets the same value for the same money in each case; there is a fascination about one transaction that the other does not possess.

Any one who has had any experience with promoters, especially those who are exploiting gold or other mines, knows that this is a correct statement of the case. Even persons who are considered hard-headed business men yield to the fascination of acquiring something for a little better than nothing. The list of stockholders in any shrewdly promoted company will contain the names of many who would not ordinarily be classed as "suckers."

It is not intended to imply that all persons who are engaged in selling mining or other promotion stocks at heavy discounts are intentionally deceiving their customers. On the contrary, they are more often than not men who fully believe in the great possibilities that they claim their propositions contain.

It is impossible to tell how much money is lost by subscribers to stock in companies which never get beyond the stock-selling stage, but a low estimate puts it at more than one hundred million dollars a year in the United States. Many of these companies are pure and simple fakes, but many of them are founded on facts plausible enough to prevent the sale of their stock from being interfered with by blue-sky laws or the regulations of the post-office.

The best protection for the ignorant purchaser of such stocks is to be found in some method that will force him to investigate the value of what he is buying. The plan recommended by the Railways Securities Commission is a long step in that direction. A man who is offered one thousand dollars of stock in a two million dollar mining company for one hundred dollars may think that he is getting a great bargain. He would not be so likely to purchase if he were offered a certificate of interest calling for one-twentieth of one per cent. of the assets and prospects of the company. He would then be more particular to inquire as to the value of the assets and prospects, for he would realize how small a portion of them he was actually obtaining.

To meet the situation a number of the states have passed laws authorizing the issue of stock with no par value, which is virtually the same as the certificates of interest recommended by the Railways Securities Commission. The number of shares is fixed, but the amount that must be paid on each share is left to the discretion of the organizers and directors of the company, except that it must not be less than a minimum, which is usually five dollars. The certificate of stock states the number of shares represented by it, but does not express any value per share. The result is that the corporation closely resembles a partnership whose members share profits in the proportion of their investments, either original or since acquired.

There are several interesting questions that arise in discussing stock of this character. Naturally the first is as to the value of the stock. In order to ascertain the value per share it is imperative that the number of

shares outstanding shall be expressed on the balance-sheet. Even the most ignorant stockholder must realize that he owns that portion of the enterprise that is represented by a fraction of which the number of shares he holds is the numerator and the total number of shares outstanding is the denominator. His proportionate interest being thus determined, he is inevitably led to inquire as to what constitutes the property of which he owns an undivided fraction. Even if he realizes that this property is the net worth of the business represented by the paid-in capital and the subsequently acquired profits, he will get a good idea of the real value of his stock. The assets may be overvalued, but there is no reason for including among them purely fictitious items like patents, franchises and goodwill, which are necessary in the fixed capital companies in order to make the net assets balance the capitalization. The fictitious items not having been paid in could not get on the books, because the capital stock is issued only for the amount of cash or other assets contributed.

However, this would not prevent the giving of stock to a promoter for services valued at the proper amount to represent the stock. That is, if the stock is being issued at sixty dollars a share, the promoter may value his services at sixty thousand dollars and be given one thousand shares to represent them. A scrutiny of the assets would still be necessary, but that scrutiny is much more apt to be given when the stockholder realizes that he owns an undivided fractional interest in the assets rather than a specified number of dollars.

In the balance-sheet the capital stock would show at the amount that had been paid in. Thus if a company is organized with an authorized capital of 5,000 shares of which 3,000 had been paid for at the agreed price of $60.00 each, the balance-sheet would read

Capital stock 3,000 shares		180,000.00

It could not be shown as it might be in a fixed capital company

Capital stock	300,000.00	
Less unsubscribed	120,000.00	
		180,000.00

because the unsubscribed 2,000 shares have no par value and may finally be subscribed for on a basis entirely different from $60.00.

However, if 3,000 shares had been subscribed for and they had not all been paid up, the statement could be

Capital stock, 3,000 shares	180,000.00	
Less unpaid	45,000.00	
		135,000.00

leaving it in doubt whether $45.00 had been paid on each of the 3,000 shares, or 2,250 shares had been paid in full and 750 shares had paid nothing, or all had paid something and some had paid in full. If it were desired to show the exact condition, it would be necessary to say:

Capital stock 3,000 shares, viz.:		
1800 shares in full	108,000.00	
1200 shares not paid in full	27,000.00	
		135,000.00

The next question that arises concerns the treatment of profits when they are made. If the company with 3,000 shares at $60.00 should make $15,000.00, either of two dispositions of the surplus is possible. It may be credited to capital or to surplus. If credited to surplus it may afterwards be used in payment of dividends if so desired. If credited to capital the entry would be legitimate because there being no fixed par value, it is not necessary to keep the capital stock account at any fixed figure. However, the crediting of the profits to capital would probably act in the same way as does a stock dividend in the ordinary company and would change surplus available for dividends into fixed capital. Probably, if profits accumulated, part of them would be transferred to capital and the remainder left in surplus as an "anchor to windward" to be used in case of emergencies. One point to be noticed is that the additions to capital are not limited to what is necessary to bring the stock to a value of $100.00 a share. Since there is no fixed par, the stock may be made to be worth any amount.

If it were decided to issue and sell some of the unsubscribed stock after the company had accumulated a surplus, the total amount received would be credited to capital if the previous accumulations had been added to capital account. Otherwise, the credit to capital would be for the same amount per share that the original stock was sold for and the rest of the payment would be credited to surplus. That is, if the original stock consisted of 3,000 shares at $60.00 and there were $30,000.00 in undivided profits on hand, the stock would be worth $70.00 a share. If 1,000 shares of the unsubscribed stock is now sold at $75.00 a share the entry will be:

Cash	75,000.00	
Capital stock		60,000.00
Surplus		15,000.00
For 1,000 shares sold at $75.00		

The capital stock account will now have a credit balance of $240,000.00 and surplus $45,000.00, a total of $285,000.00 for 4,000 shares, making the value per share $71.25. The 3,000 shares of old stock have received the benefit of only $3,750.00 of the $5,000.00 bonus paid by the new stockholders who themselves receive the benefit of the other $1,250.00 in their share of the surplus.

It might be claimed by the old stockholders that all the bonus belonged to them because they had developed the business that made it possible to exact the bonus or premium. This could be given to them by an entry made prior to putting the sale of the new stock on the books, but it would have no effect, unless a dividend of $5,000.00 were declared and paid or at least credited to "dividends payable" while there were still only 3,000 shares outstanding. If the $5,000.00 were merely credited to surplus, the following would be the entries:

Bonus from new stock	5,000.00	
Surplus		5,000.00

and when the new stock was sold:

Cash	75,000.00	
Capital stock		60,000.00
Surplus		10,000.00
Bonus		5,000.00

The surplus would be as before, $45,000.00, and the old stockholders would have received the benefit of only $3,750.00 out of the $5,000.00 bonus. It is important that the disposition of the bonus be specifically determined when the sale is made. If nothing is said about it the bonus will undoubtedly belong to the company itself and be shared by the new stockholders.

Thus far we have considered the case of a company having only one class of stock. The situation becomes more complicated when there is preferred as well as common stock. From the natuıe of preferred stock it naturally follows that it should have a fixed par value. The holders of such stock are entitled to an agreed amount per share in cash as income. When the stock is cumulative preferred the payment may be deferred, but it must be made eventually if the business succeeds. Without the consent of the holders the directors cannot substitute a stock dividend for one payable in cash; therefore if there be no fixed par to the preferred stock, no profits can be added to the face value. There might be one possible exception to this in case the preferred participated equally with the common in any dividends beyond that guaranteed to the preferred. If such a distribution of excess profits were made to the common in the form of an addition to the face value of the common stock, the directors might claim the right to make the same disposition of the excess allotted to the preferred. Even in this case the dividend could be made by issuing additional shares of preferred stock instead of adding to the face value of the preferred stock already issued.

When a company has cumulative preferred stock the right to the surplus no longer resides wholly in the common stock. Even if the preferred dividends are paid up in full to date, it may be unwise to give the common stock all the surplus, either in cash or as a credit to the face value, because the profits of the next succeeding period may not be sufficient to pay the preferred dividend for that time. This is on the theory that profits having once been credited to capital stock have become fixed capital which cannot be reduced by the vote of the directors alone.

If a company with 6% cumulative preferred stock of 5,000 shares at a fixed par of $100.00 and common stock with 5,000 shares of no fixed par issued at $60.00, had an accumulated surplus of $90,000.00, the situation would be

6% cumulative preferred stock 5,000 shares	500,000.00
Common stock, 5,000 shares	300,000.00
Surplus	90,000.00

If the dividend on the preferred for the last six months had not been paid it would be incorrect to say that the book value of the common stock was $390,000.00, because the preferred stock has a claim on the surplus for a 3 per cent dividend, or $15,000.00. If the directors now declared dividends of 3 per cent to the preferred and 5 per cent to the common, the situation would be

6% cumulative preferred stock	500,000.00
Common stock, 5,000 shares	300,000.00
Preferred dividend payable	15,000.00
Common dividend payable	15,000.00
Surplus	60,000.00

The directors would have the right to change the surplus into fixed capital by crediting all the $60,000.00 to the common capital stock account, bringing the common stock to $360,000.00 or $72.00 a share. If they did this, they would run the risk of not being able to meet the next semi-annual dividend on the preferred, not to mention the danger of having an actual deficit, in case of a bad fire or other unforeseen loss. It would be wiser to retain at least a large portion of the profits in surplus, which is to a certain extent under the control of the directors. However, this is financial rather than accounting advice.

This is not the same as the usual advice not to dissipate all the profits in dividends, because the profits are still retained whether they are added to the capital or are left in surplus. It is merely a question as to whether or not the profits shall be fixed as capital or left in surplus where they are available for future dividends. If the advice of the accountant is asked he should favor the carrying of a considerable portion of the profits in a substantial surplus.

RESERVE FOR FREIGHT TO BE PAID

Editor, Students' Department:

SIR: I would like to ask your assistance in regard to one of the accounts on the books of our company, the details of which are as follows:

More than a year ago, we shipped a large number of carloads to England, the freight on which was to be prepaid. It is customary to pay the ocean freight on prepaid shipments at the time the goods are loaded on the steamer. When we closed our books last January, there were still thirteen cars at the seaboard awaiting transshipment.

On account of the abnormal conditions, the ocean rates were very high, and the freight on these thirteen cars amounted to something like $19,075.00. In view of the amount being so large, I decided that it should be taken into consideration when determining our net profit for the year, and therefore created a "reserve for prepaid ocean freight" account, charging off the amount.

Subsequently, however, only four carloads were forwarded, the freight on which amounted to approximately $6,000.00, and owing to the fact that the government requisitioned practically the entire steamer space, the transportation company found it impossible to ship the remaining nine cars. We were therefore compelled to have these returned to Cleveland, and as a result our reserve account still shows a credit balance of $13,000.

Will you kindly advise me whether I handled this item correctly, and also as to the method of closing the reserve account. This was the first

time I opened a reserve account on our books, and I have been greatly puzzled as to just what should be done with this balance.

Would this be considered a profit on this year's business? What effect would it have on our excess profits tax?

Cleveland, Ohio. H. C. K.

Owing to the lack of complete information in regard to the shipment, it is necessary to assume three possible conditions:

1. The goods were consigned.
2. The goods were sold c.i.f. at a fixed price which has been charged to the customer and credited to sales.
3. The goods were sold, but no entries had been made for the sale, or, if any had been made, they were merely pro forma and included only the cost of the goods and freight to the port of shipment.

1. If the goods were consigned, no notice should have been taken of the ocean freight until it was paid, and then it should have been added to the cost of the goods in the consignment account. However, if the credit were made to a reserve account the offsetting debit would be to the cost of the consignment, and not to an expense account of freight. The correcting entry for the goods not shipped would be a debit to the reserve and a credit to consignment account. As no profit had so far been taken, there would be no loss to be taken up, except the railroad freight on the unsold goods.

2. In this case, the amount charged the customer and credited to sales would have included the cost of the goods, all freight and the profit on the deal. If the books were closed with these entries unchanged, it was necessary to charge the expense account of freight and credit the reserve, since the freight was included in the credit to sales and therefore to profits.

If the tax return were made on the basis of sales which included the carloads not finally shipped, the profits on which tax was paid were overstated to the extent of the profit that would have been made on the goods not finally shipped. It would probably be difficult to collect a rebate of taxes by claiming an error in the sales. The reversing entries in the current year will offset the overpayment, if the profits are large enough to stand the deduction.

In the abnormal uncertainty prevailing in regard to shipping conditions, it would have been an error to enter this sale as a completed transaction. Delivery is an essential feature of a sale and until delivery is reasonably certain no sale has been made, unless the goods were sold f.o.b. Cleveland, the customer then accepting delivery in Cleveland. The conditions show that this was not the case.

If the entries for the sale had been made, they should have been reversed before the books were closed, the goods being taken back into inventory at cost.

3. If no entries had been made, or only those which covered the cost, no profit would have been taken, and the correcting entries would involve no loss. The conditions would be the same as in the case of the consignment of the goods.

In any event the charge-off of the reserve this year would not be a profit. The only profit involved would be in case (2), and that profit was recorded last year. The reversing entries would represent a loss, or rather a correction of last year's surplus. As the credit of the freight to reserve last year reduced the apparent profit on the sale, the charge back to reserve this year will reduce the apparent loss on the return of the goods.

FREIGHT ON RETURNED CONSIGNMENTS

Editor, Students' Department:

SIR: Recently in closing a consignment account we found it necessary to have a quantity of goods returned, and these goods when received were placed in our finished stock.

Some of our accounting force hold the opinion that the freight on the return of these goods should be added to the cost of the article and used, when the goods were re-shipped, as part of the cost of manufacture.

There is some difference of opinion as to the handling of this item, and in order to settle the matter so that everyone will feel that his ideas were given due consideration, I would ask that you kindly give me your views of the disposition of the item.

Yours very truly,
L. F. B.

In handling consignments-out the goods should be charged at cost to the consignee in an account in which its character is specifically designated as a consignment and not as a regular sale. To the cost at the factory may be added the freight to the consignee, on the ground that the goods are worth what it cost to get them into the hands of the consignee or they would not have been sent to him.

When the goods are returned to the factory by the consignee, the only argument in favor of their being charged back at cost plus freight out and back again would be that the goods have been increased in value by the two journeys. If those of the accounting force who hold that both freights should be added to the cost value are able to prove in what way the goods have been benefited, instead of being injured, by their travels, their contention may be accepted. Otherwise, they must be taken back into finished stock at their cost, at best, and both freights must be charged off as expense.

The same reasoning would apply to goods returned on a regular sale. Surely no one would think of charging them back to stock plus any freight.

What is called in logic the "reductio ad absurdum" is often helpful. Suppose the same goods were sent out and returned several times, and the freights were added each time, the value might become so great that they could never be sold at a profit. If this treatment is absurd as applied to several shipments, it is only a degree less so when applied to one.

FIRE LOSS

Editor, Students' Department:

SIR: Will you kindly give me your opinion on the following questions in regard to recording transactions of complete loss by fire.

It is desired by the firm to show the total amount, at a glance, of the salvage and insurance received.

Is it correct to enter through the voucher register, and charge total column to accounts receivable, all sales of parts of buildings, machinery, materials, etc., purchased and entered originally in the voucher register, the credit being to salvage account?

Should supplies purchased to be used in making salable the materials and machinery saved from fire and wages incurred for them, be debited to salvage account?

In closing the accounts, should the balance of buildings, plant and machinery and inventories accounts be debited to salvage account and the balance of salvage account be debited to surplus account?

In making out the profit and loss statement for the part of fiscal year when the plant was operated, should an approximate percentage of inventory on hand at time of fire, be taken to find the cost of goods consumed?

Very truly yours,
A STUDENT.

The proper procedure in handling a total fire loss is to open a fire loss account. This account is charged with the net book value of the buildings and machinery. To put the net value on the books, the reserves for depreciation must be transferred by journal entry to the credit of the fixed asset accounts.

The materials inventories must be approximated by the gross profit method, unless an adequate cost system is in use, in which case the book inventories should be used. The gross profit method can be used only when there has been a virtually constant relation for several years between the cost of goods and the sales. The inventory is then approximated as follows:

Sales since last closing		xxx
Inventory at last closing	xxx	
Purchases since	xxx	
Gross profit at x%	*xxx*	*xxx*
Remainder is inventory lost		xxx

This inventory is credited to materials account to close the books and is debited to fire loss account.

Fire loss account, having been charged with all the property lost, must now be credited with salvage recovered and with money paid by the insurance companies. The balance of fire loss account is then transferred to the debit or credit of surplus. The balance may be a credit if the concern has charged off excessive depreciation, so as to bring the net carrying value below the insurance replacement value.

The total loss, the salvage, the settlement and the net result must be recorded in the fire loss account, and not in the salvage account. The fire was the important event and caused the loss—the salvage was only incidental.

If the salvage involved any transactions other than the mere sale of junk, etc., a salvage account should be opened. This account should be charged with the materials and labor required to render the salvaged articles salable and should be credited with the sales. The balance of the account should then be credited to fire loss account.

The use of the term voucher register is probably a slip of the pen. Sales are recorded in a sales register, not in a voucher register. However, the salvage sales should not be recorded in either register, unless the sales register has a sundries column from which the items can be posted to the credit of salvage account. These sales should be recorded by journal entries, except where they are made for spot cash, in which case they would appear in the cashbook only. The sales register should be used only for regular sales of the merchandise made by the factory.

INTEREST IN PART PAYMENTS

Editor, Students' Department:

SIR: What is the proper method of treating a mortgage note for $2,500.00 on which the mortgagee has the privilege of paying $20.00 monthly and interest at 6 per cent until paid? Would you give a receipt the first of every month for $20.00 as a part payment and charge or collect the interest at the end of each year? Would it be advisable to calculate the interest each month and specify in the receipt the amount applicable to principal and interest? R. L. R.

The proper treatment of payments of interest and principal on a mortgage note would depend entirely upon what the contract stated in regard to the distribution of monthly payments between principal and interest.

For instance, I have before me a note requiring the payment of $2,000 in the following manner: "The $2,000 is to draw interest at the rate of 6 per cent per annum and is to be paid as follows: the maker hereof is to pay to the said payee or order $40 on the first day of each and every month hereafter until the said sum of $2,000 and the interest thereon is fully paid; that is, the interest due from time to time on the unpaid balance is to be first deducted from said payment of $40 and the balance remaining is to be applied on account of the said principal sum of $2,000."

This recital clearly indicates what distribution is to be made of the monthly payments; and endorsement should be made on the note, showing the amount of the cash received for interest and the amount received on the principal. It would not be sufficient for the holder of the note to give a receipt for the payment because of the fact that the paper is a negotiable instrument and, if the part payments were not recorded on the note itself, the note might be sold by the holder and a holder in due course could enforce payment for the total note.

If it is the intention that the $20 monthly payment, in the case in question, is to apply entirely upon the principal, this should be endorsed on the note as an application against the principal. The question would then arise as to whether at the end of the year the debtor would pay interest on the principal outstanding at the beginning of the year or on the average principal outstanding during the year.

Unless specified differently in the contract, the interest to date on the then unpaid balance would have to be paid every month. The law is that interest takes precedence of principal, unless otherwise stipulated. That is, if the contract is silent as to when the interest shall be paid, any

payment made must first be applied to the payment of the interest accrued at that time and only the remainder will be applied in reduction of the principal. In the contract which we have mentioned this is plainly stated, probably to avoid misunderstanding, but it was not necessary to state it, as the procedure would have been the same in any case. On that contract the same payment of $40 is made every month, but the division between principal and interest varies thus:

1st mo.	payment $40.00;	interest on	$2,000.00,	$10.00;	principal	$30.00
2nd mo.	" 40.00;	" "	1,970.00	9.85;	"	30.15
3rd mo.	" 40.00;	" "	1,939.85	9.70;	"	30.30

and so on.

In the case cited by our correspondent the expression "$20.00 monthly and interest" can be construed to mean only that the interest is an addition to the $20.00, not that it is included in it. The payments and the interest would constantly decrease, but the reduction of principal would not vary, thus:

1st mo.	payment $32.50;	interest on	$2,500.00,	$12.50;	principal	$20.00
2nd mo.	" 32.40;	" "	2,480.00,	12.40;	"	20.00
3rd mo.	" 32.30;	" "	2,460.00,	12.30;	"	20.00

The law giving preference to interest is not at all well known to business men, and is seldom or never followed in ordinary commercial transactions, because the difference in the total interest is very small when the time is short and the amounts are not large. What is known as the commercial rule is usually followed. This requires the calculation of all the credit and all the debit items of interest separately and the payment of the difference. As an example take the following account:

Jan'y. 1,	Merchandise	1,200.00	Feb'y. 10, Cash	800.00
March 2,	"	1,600.00	March 17, "	1,100.00
May 1,	"	900.00	April 16, "	700.00
			May 1, "	300.00

It is proposed to settle this on June 30th with interest at 6 per cent. per annum calculated at 360 days to the year.

The commercial plan would be:

Dr. $1,200	180 days	36.00	Cr. $800	140 days	18.67
1,600	120 "	32.00	1,100	105 "	19.25
900	60 "	9.00	700	75 "	8.75
			300	60 "	3.00
		77.00			49.67

which shows a debit net of $27.33, and a total due of $827.33.

The legal or "United States" plan would be:

Jan'y. 1,	Debit		$1,200.00
Feb'y. 10,	Payment 800.00 less interest 40 days on 1,200.00	8.00	792.00
			408.00
March 2,	Debit		1,600.00

March 17, Payment 1,100 less interest 20 days on 408.00, 1.36		2,008.00
" " 15 " " 2,008.00, 5.02	6.38	1,093.62
		914.38
April 16, Payment 700.00 less interest 30 days on 914.38	4.57	695.43
		218.95
May 1, Debit, net		600.00
		818.95
June 30, Interest 15 days on 218.95 .55, and 60 days on 818.95, 8.19 =8.74		8.74
Amount due		827.69

This shows a difference of only 36 cents, which is considered negligible on such amounts.

In the example quoted by us the method pursued would leave at the end of the 57th month an amount due of $26.99. In the 57 months there would have been paid in at $40.00 per month $2,280.00. If the small balance were paid at once the total amount paid would be $2,306.99. By the commercial method the interest on $2,000.00 for 57 months would be $570.00, a total debit of $2,570.00. Against this there would be a credit of 57 times $40.00 or $2,280.00 and interest on the first $40.00 of $11.40, diminishing each month in arithmetical progression to 20 cents the last month, or $330.60, a total credit of $2,610.60. As the credit is $40.60 more than the amount due, while by the United States rule there is still $26.99 due, it is seen that the commercial rule in this case favors the borrower to the extent of $67.59 which is by no means a negligible amount on a $2,000 note.

Accountants and bookkeepers should be more familiar than they are with the laws of interest. They can often save their clients or employers considerable sums if they know the effect of the different methods of calculation.

NOTES OR BILLS PAYABLE

Editor, Students' Department:

SIR: Does the accounting profession differentiate between bills payable and notes payable not only practically but also theoretically? One party contends there is no difference; the other says there is, with the explanation that notes payable, are the regular promissory notes and should always bear interest and do not recite that they are given to liquidate a specific kind of transaction, merely value received, whereas a bill payable is a trade acceptance, a bill of exchange, certified cheque or accepted sight draft.

G. Q. D.

The accounting profession has not differentiated as yet between notes payable and bills payable.

In England and in continental Europe drafts or bills of exchange have been a more customary method of handling credit transactions than notes payable. In England, where most of our accounting terminology origi-

nated, bills of exchange were much more common than notes; therefore they used the term bills payable and bills receivable, and whenever a few notes were given they were entered in the account with the bills.

In this country the custom has been exactly the reverse. We have been accustomed to giving notes rather than accepting bills of exchange; but we have used the English terminology of bills payable until recent times. Realizing that the term bills payable was not as appropriate in this country as in England, a movement has been on foot to change the terminology from bills payable to notes payable and this movement has met with considerable success so that the term notes payable rather than bills payable now frequently appears in balance-sheets.

Strictly speaking a promissory note is a note payable; a trade acceptance is a bill payable; but I am inclined to think that as trade acceptances become more prevalent they will be recorded in a trade acceptance account rather than a bills payable account.

The statement that notes payable should always bear interest is not correct. Interest is an immaterial detail which may be found in a bill of exchange or trade acceptance as well as in a note and is not essential to either. In an accounting sense bills payable are always notes or acceptances payable at a future date, and the term does not include cheques or sight drafts.

The objection to the term bills payable is that in this country many business men not being accustomed to bills of exchange think the term refers to the bills rendered by their creditors which are payable every month.

ANONYMOUS LETTERS

This department continues to receive anonymous letters asking for information. Unless name and address both are given, no attention is paid to such requests as a usual thing. It is to be noted that a letter signed J. L. W. with the address of New York is an anonymous letter.

If the enquirer does not wish his name used, he can sign any initials or anything else, provided he give his real name and address below with the request that they be not used. This request will always be granted.

Alabama Society of Certified Public Accountants

At a meeting held in Birmingham, Alabama, September 27, 1919, it was decided to organize the Alabama Society of Certified Public Accountants. H. S. Miller was elected president, and J. A. Harden secretary and treasurer.

Henry J. Falk

Henry J. Falk, president of the Colorado State Society of Certified Public Accountants, died in Denver, September 27th. Mr. Falk was a member of the American Institute of Accountants and was keenly interested in the development of the profession throughout the country.