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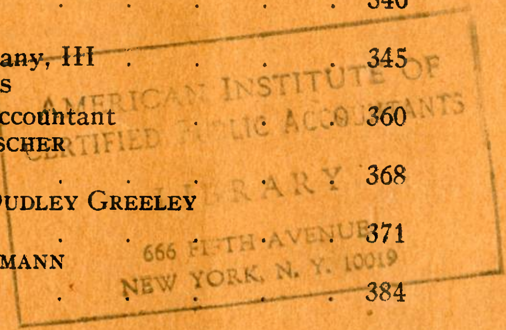
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Authors of Articles in This Issue of THE JOURNAL OF ACCOUNTANCY

L. L. Briggs. Associate Professor of Economics, University of Vermont, Burlington, Vermont.

F. W. Thornton. Member, American Institute of Accountants. Certified Public Accountant (New York). With Price, Waterhouse & Co., New York, New York.

H. G. Humphreys. Associate, American Institute of Accountants. Certified Public Accountant (Oklahoma). With the Skelly Oil Company, Tulsa, Oklahoma.

Reinhard M. Fischer. In practice, New York, New York.

Spencer Gordon. Member of firm, Covington, Burling & Rublee, Attorneys, Washington, District of Columbia.

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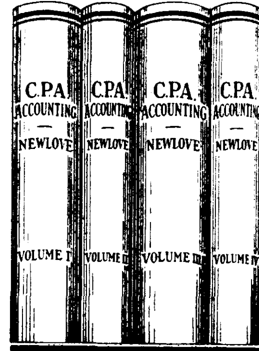

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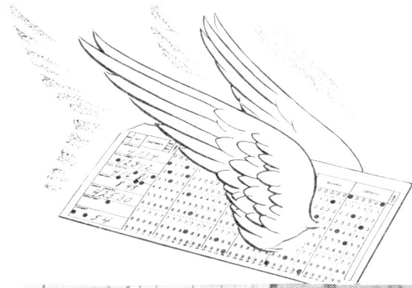

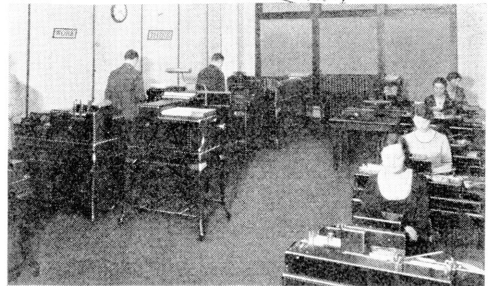

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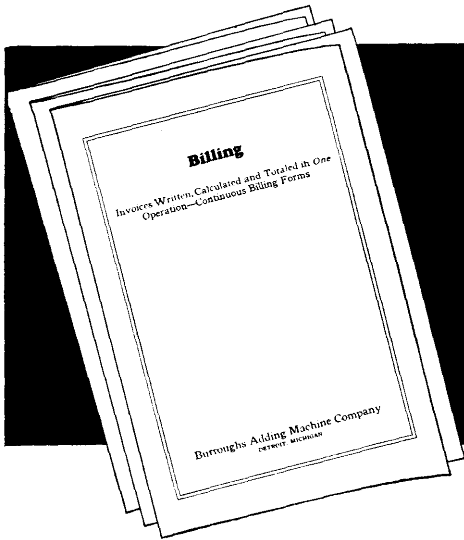

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VOL. 55 MAY, 1933 No. 5

EDITORIAL

Chicago Stock Exchange Requires Certified Statements

Following the recent action of the New York stock exchange requiring that all applications for listing of corporation securities be supported by financial statements certified by independent public accountants, the second largest exchange has taken similar action. On March 21st the Chicago exchange adopted regulations from which the following excerpts are taken:

"Clear and informative financial statements, including a balance-sheet, profit-and-loss statement and an analysis of surplus, shall be submitted as part of each application. Such financial statements shall truly disclose the past operations and present condition of the company and shall be certified to the Chicago stock exchange by duly qualified independent public accountants, whose certificate shall be set forth in full as a part of the application."

Later in the same pronouncement the Chicago exchange makes the following requirement:

"Applicant companies shall agree to mail to the exchange and to their stockholders with the notice of the annual meeting a report of the operations for the preceding fiscal year, including a balance-sheet, profit-and-loss statement and analysis of surplus. Such financial statements shall be clear, complete and informative. They shall truly disclose the operations and condition of the company and shall be certified by duly qualified, independent public accountants whose certificate in form satisfactory to the exchange shall be attached."

It will be noted that the language in these two paragraphs is practically identical with the rules of the New York exchange. The movement which was inaugurated in the early part of this year to require full exposition of financial condition is thus spreading, as was expected, throughout the country, and there seems good reason to believe that in addition to the exchanges which have already participated practically every important exchange throughout the land will see the wisdom of making the requirement for independent audit.

Listing Dependent on Distribution

In the Chicago regulation there is a highly interesting development. Paragraph 7 reads as follows:

"Securities will not be listed coincident with a public offering. Applications will only be considered when the company demonstrates that the securities to be listed are sufficiently distributed to the public to assure a free and open market."

This rule is really an effect of the dissatisfaction which has often been expressed relative to the common practice of listing securities "when, as and if issued." There are many reasons why this custom is unfavorably regarded, and certainly there can be no violent objection to withholding listing until, as the rule says, "the securities are sufficiently distributed to assure a free and open market." This is one of the many indications of a change of sentiment in the security markets of the country, and it undoubtedly makes for a better control of dealing in securities. The old notion that the securities of any corporation of reputable standing could be safely offered for purchase and sale prior to actual issuance was founded in part upon a too confident belief that the issuance would take place. Anything which will limit trading to the securities which have a free and open market will be of benefit to all concerned.

Effects of Bank Holiday

Several important developments have followed the recent compulsory holiday which closed the banks throughout the country. The public was aroused to a spirit of inquiry, and a demand arose and continues to arise for reformative measures which shall forever prevent the creation and the continued existence of banks which are fundamentally unsound. Someone said in a speech recently that the bankers have "got religion."

It does not seem to us that the spiritual conversion has been so much on the part of bankers as it has been of the general public. The old days when people thought that a bank was strong because it was a bank are gone for good. Indeed, the glory of being a director of a bank is not as lustrous as it was. Some directors have found that the burden of responsibility and the actual liability of directorate are far too heavy and outweigh the prestige which such directorates were supposed to imply. It begins to look as though the banks of discount hereafter will be banks of discount and nothing else. The voluntary separation of the Chase National Bank of the state of New York from its subsidiary, the Chase Securities Corporation, was one illustration of the change of heart which animates not only small and unimportant banks but the greatest institutions in the country. In a letter from the president of the Chase Bank to shareholders he says:

"On March 8 last I issued a public statement pointing out that the experience of the past ten years had clearly indicated the advisability of separating commercial banking from the general business of investment banking. The Chase National Bank had for some time been giving serious consideration to the question of severing its connection with its security affiliates and of limiting its future participation in investment banking solely to handling obligations of the United States government and of states and municipalities and other securities as provided in the national banking act."

When the largest bank in the world, which has held as its subsidiary one of the largest securities corporations of the world, finds it desirable in the public interest to divorce these two fields of activity there must be sound logic underlying such a decision. It is quite certain that many of the subsidiary companies of banks created to handle investments not strictly within the range contemplated by the national banking act have been conducted with due regard for the protection of investors. Nevertheless, the business of banking is more secure when it remains within its own historic bounds.

Bank Audits are Desired

Another outcome of the bank holiday, or, it would be preferable to say, of the conditions which induced the bank holiday, is a more emphatic demand that the audits of banks shall be thorough and independent. In too many cases bankers have

ignored the additional safeguard which can be provided by independent audit. They have been inclined to point with pride to the examinations conducted by emissaries of the federal reserve board and of the various state banking commissions. Now, these official investigations are generally hurried and they are always confined to a fixed routine. There is little opportunity for initiative on the part of state or national examiners who are compelled to go from one institution to another, making, it is true, unheralded visits but so limited by numbers of personnel and by regulation that the interests of shareholders and depositors are apt to suffer from incomplete investigation. Indeed, the requirements laid down by the federal and state authorities look more to the written regulations than they do to the interests of stockholders and depositors. There are many things in the affairs of almost every bank which the stockholder or depositor is entitled to know. Questions of policy are not within the purview of official examiners, unless something arising from a policy affects observance of the regulations. The independent auditor goes into a bank with a competent staff of trained men and is not ordinarily so restricted by time that full investigation is prevented. It is the contention of professional accountants that they can render a service in addition to that rendered by the official representatives of governing bodies which will bring to light mistaken policies which may prevail and will render far safer the investment of stockholders and the cash of depositors. In this new movement to bring about full information the public accountant will assuredly play an important part, and it is not unreasonable to expect that the engagement of independent professional accountants will spread with a rapidity that would not have been possible had it not been for the upheaval which has shaken the entire financial structure of the country.

An Auditor's Investments

At a recent meeting of the council of the American Institute of Accountants consideration was given to the propriety of an accountant's investment in the securities of corporations of which he is the auditor. This is a point which has been under discussion for many years, and it seems to be the common opinion that an auditor should be so entirely detached from any concern, direct and personal, in the condition of a company that there can not be the slightest danger of an imputation of self-interest. It

has been said that to preclude an accountant from investing in the corporations which his firm examines is to place upon his financial plans a limitation that is unfair; but that does not seem to be a valid argument. No accountant, however wide his practice may be, numbers among his clients all the corporations in whose progress he would like to participate. However great may be the practice of an accountant there are many companies not within his clientele which offer abundant opportunity for the employment of his funds. Some professional men adopt the policy of immediately disposing of the securities which they hold of any corporation which becomes their client after the fact of investment. This has been called a counsel of perfection, but if it errs it errs on the safe side. Of course, it is obvious that a man may own a small number of shares in a corporation and be entirely uninfluenced in his professional work by the possession of such a personal interest, but the difficulty of determining where lies the line between what is substantial and influential and what is insignificant is too great. So many factors must be brought into a solution of such a problem that the answer will never be entirely satisfactory. What would be substantial for one man would be quite trivial for another. To be entirely without the range of suspicion an accountant would be wise to have no interest whatever, even in one share, of any corporation with which he was associated in a professional capacity. If it be true, as we have it on excellent authority that "virtue itself 'scapes not calumnious strokes" and "be thou as chaste as ice, as pure as snow, thou shalt not 'scape calumny," the argument for an almost quixotic restraint should prevail. At any rate the council has expressed itself finally to the effect that it does not regard with favor an accountant's participation in the ownership of companies or businesses subject to his professional investigation.

Complete Detachment is Best

There would probably be no objection raised to investment in a close corporation whose securities were never offered to the public outside the inner circle, but even in such cases there is wisdom in refraining from combining the two functions of ownership and audit. Some lawyers favor the safe rule of complete detachment, and yet in their case the position is slightly different. Impartiality is not supposed to be one of their virtues. They are engaged as special pleaders. They assume an intimate

interest. They are almost integral in the concern. Accountants, however, are in a different category. Their duty is the old triune obligation to the public, the profession, the client. No one of these three may be ignored without danger. If the public learns that an accountant who presents a favorable report of the condition of a corporation is the holder of stock or bonds of such a corporation the public may be pardoned for a little suspicion that all unwillingly and unknowingly the accountant's opinion may be slightly colored by his desire to see prosperity. Of course, everyone who knows the profession of accountancy is aware that the great majority of men in the profession are absolutely upright and would not wittingly allow themselves to be prejudiced in any way, but then, admitting for the sake of argument that it is possible for a man to separate his finances from his practice, there is always the opinion of other people to be considered, and a position of absolute disinterestedness is the strongest ground upon which an accountant can stand. The council has said in effect that auditing and ownership should not be contemporaneous, and that, it seems to us, is good sense and right doctrine.

The Greatest Opportunity of All

What a day is dawning for accountancy. When the hurly-burly's done, when the battle's lost and won this profession will go forward into a region of marvelous opportunity. Everything points to more accomplishment for the good of humanity—and incidentally, of course, for the good of the profession—than has ever been known in the past. When the income-tax laws were written on our federal statute books there came a recognition of the vitally important part which accounts play, and accountants were suddenly swept into a position of prominence that rather astonished them. They were called upon to meet the requirements of the new laws, and business as a whole was compelled to pay attention to the accounting which had been more or less a matter of minor concern. Now it appears that an even greater stimulus will be given to accountancy, and that the accountants of this country, and indeed of all countries, will step up to a higher plane than they have ever occupied before. Nearly all the legislation and administrative regulations which are following upon each other's heels with an amazing rapidity are an earnest of the need for accounts which shall tell the truth and all the truth. The accountant stands face to face with a challenge that he must

meet or perish. The evident intention of the federal government to prevent the flotation of unsound securities, the prospect of reform in banking practice, the movement to bring in protection of the public in every way—all these involve labor for the accountant and a chance to do a magnificent work for the country. It is gratifying to know that the accountants themselves apprehend these truths. At a meeting of the council of the American Institute in April the reports of committees indicated the awareness of the profession. Almost every phase of activity with which the accountant is or is to be concerned seems to have been considered in the reports of the committees which were presented to the council. The Institute as a whole stands ready and eager to take part in this onward march. One who remembers the early days of accountancy must regard with gratification the change which has taken place in public sentiment and the recognition which is now given to the accountant as a factor in the whole fabric of commerce and industry.

Many New Men Will Be Needed

Fears have been expressed that the recent scarcity of work for accountants will lead to a shortage of men in the near future. Some students of the situation seem to feel that, because many men have been unable to find employment even during the ordinarily busy season of winter, other men will be discouraged and will be inclined to adopt other vocations where there is greater probability of steady employment. As a matter of fact, however, accountancy has not suffered more than other callings. In many ways accountancy has been less affected than most other professions. For example, engineering and architecture have been almost at a standstill because there has been practically no construction. Business, however, still exists, and accounts must be kept and should be audited. Perhaps, after all, the depression may encourage new men to come into accountancy because when the whole field has been surveyed it may be found that in accountancy lies opportunity as great as that to be found anywhere. Many new men will be needed. (Let no advertiser quote this for seductive purposes.) The men who will be wanted will be good men, better perhaps than their forerunners, because they will have to cover a wider scope, meet a greater responsibility and encounter a more alert public. They will be college men, probably, and they must be well trained,

keen, knowing a good deal about economics of the new day—that illusive day which seems always about to dawn and then to fade away. It will, however, dawn at last, and perhaps in that day there will be a new accounting. Old customs may be thrown out. Better ways of analysis and report may ensue. And for that new men must be ready and adaptable to all that is truly better than tradition. No one can foretell how the future will run, but it is sure that the men who come into the profession now will have a task of tremendous potentialities. The brightness of their future will excite the envy of those who labored through the early days when recognition had not come.

Treasury Stock and General Corporation Statutes

By L. L. Briggs

Having had occasion to make a study of the statutory law relative to treasury stock it occurred to me that a summary of the results of this investigation might be helpful to those who are interested in accounting.

First, let us consider the definition of treasury stock. According to the Ohio (*General Code*, sec. 8623–2) statutes treasury stock means shares issued and thereafter acquired by the corporation. In Rhode Island (*General Laws*, ch. 248, sec. 53, as amended ch. 1735, *Public Laws 1931* and ch. 1941, *Public Laws 1932*) treasury shares are those which have been issued and are owned or held by the corporation.

Next, let us determine the conditions under which a corporation may purchase its own stock. Alaska (*Compiled Laws*, ch. 8, sec. 8), Arkansas (*Corporation Statutes 1931*, ch. 1, art. 2, sec. 7), Florida (*Corporation Laws 1925*, art. 4, sec. 8), Louisiana (*General Corporation Laws 1928*, sec. 23), Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended *Laws 1931*, ch. 480), Ohio (*General Code*, sec. 8623–41), South Dakota (*Revised Code*, part 17, ch. 1, art. 2, sec. 8777), and Tennessee (*Public Acts 1929*, ch. 90, sec. 12) permit a corporation to purchase its own shares from surplus assets over liabilities and capital. California (*Civil Code 1931*, div. 1, part. 4, tit. 1, ch. 10, sec. 342) allows purchases only from earned surplus while Louisiana (*General Corporation Laws 1928*, sec. 23) specifies that the surplus must be that available for dividends and the purchase must not violate the contractual right of any other class of shares. In Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended laws 1931, ch. 480) the surplus available for the purchase of a corporation's own shares may include that created by reduction of capital stock. North Dakota (*Compiled General Laws*, ch. 12, sec. 4531) generally requires that the purchase be made from surplus profits but the corporation's articles may provide otherwise and with the unanimous consent in writing of all stockholders the purchase may be made from capital. Oklahoma (*Compiled Statutes 1921*, sec. 5320) has similar provisions. Nevada (*General Corporation Laws 1925*, sec. 9, as amended 1931, 420) is even more liberal, for it allows a corporation to pur-

chase its own shares of stock with capital, capital surplus, surplus or other property or funds. Ohio (*General Code*, sec. 8623–41) provides that a purchase from surplus must be properly authorized and must not favor any shareholder over another.

According to the New York penal law (*Consolidated Laws*, ch. 40, sec. 664) the directors of a corporation are guilty of a misdemeanor if they apply any funds except surplus to the purchase of shares of its own stock.

The statutes of Colorado (*Annotated Statutes* (*Mills*, 1924) sec. 996), Delaware (*General Corporation Law*, art. 1, sec. 19), Indiana (*General Corporation Act 1929*, art. 1, sec. 3), Michigan (*General Corporation Laws 1931*, sec. 10), Missouri (*Revised Statutes*, sec. 10151, as amended laws 1927, p. 394), Nevada (*General Corporation Law* 1925, sec. 9, as amended 1931, 420), Rhode Island (*General Laws*, ch. 248, sec. 5) and West Virginia (*Corporation Laws 1930*, art. 1, sec. 39) permit a corporation to purchase its own stock if its capital is not impaired by such purchase. It is interesting to note that an earlier Colorado (*Annotated Code* (*Mills*, 1921) sec. 996) statute forbade a corporation to acquire treasury stock by purchase.

In Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) a corporation may purchase its own shares, but it must not render itself insolvent by so doing nor may it purchase such shares when insolvent. California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342) and Ohio (*General Code*, sec. 8623–41) prohibit such purchases if there is reasonable ground for believing that the company is unable or the purchase will make it unable to satisfy its obligations and liabilities. Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended laws 1931, ch. 480) provides that the purchase must not reduce assets to less than the liabilities and capital and if a purchase is made when the corporation is insolvent the persons receiving payment are liable to the corporation, its trustees or receivers to the extent of such payment for the debts existing at the time of payment. California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 14, sec. 365) holds purchasing shareholders to a similar liability. Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) makes the directors personally liable for the debts of the corporation existing at the time if they assent to purchases when the corporation is insolvent or is rendered insolvent thereby.

The statutes of Michigan (*General Corporation Laws 1931*, sec. 10) and Rhode Island (*General Laws*, ch. 248, sec. 5) allow corporations to "acquire" their own stock while the laws of Indiana (*General Corporation Act 1929*, part 2, art. 1, sec. 3) state that a corporation may "own" its shares.

Several states, including Illinois (*General Corporation Act*, sec. 6) New Jersey (*General Corporation Act 1896*, ch. 185, sec. 1, as amended to end of 1932) and Wisconsin (*Revised Statutes*, 182.01 and 182.05), expressly permit a corporation to purchase personal property necessary to carry on its business. Since shares of a corporation's own stock are personal property it is permissible for a company to acquire treasury stock for legitimate corporate purposes in these jurisdictions.

Some states require the approval of stockholders before allowing corporations to acquire treasury stock by purchase. In Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) a corporation must secure the approval of stockholders owning three-fourths of the entire capital stock at a stockholders' meeting warned and held for that purpose. Louisiana (*General Corporation Laws 1928*, sec. 23) requires the affirmative vote of two-thirds of the voting power of each class of shares outstanding when the purchase is for purposes other than those specified. Ohio (*General Code*, sec. 8623–41) permits a purchase of this kind when it is authorized by the vote of two-thirds of each class of stock outstanding under conditions named. South Dakota (*Revised Code*, part 17, ch. 1, art. 2, sec. 8777) merely specifies that the stockholders' approval is necessary for the purchase.

California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342), Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423), Kentucky (*Statutes*, ch. 32, art. 1, sec. 544), Louisiana (*General Corporation Laws 1928*, sec. 23), Ohio (*General Code*, sec. 8623–41), Vermont (*General Laws*, tit. 25, ch. 210, sec. 4920), and Virginia (*Revised Code*, ch. 147, sec. 3807, as amended to 1932) permit a corporation to acquire its own stock in satisfaction of an antecedent debt. California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342), Louisiana (*General Corporation Laws 1928*, sec. 23), and Ohio (*General Code*, sec. 8623–41) allow a corporation to collect or compromise in good faith a debt, claim or controversy with any stockholder. Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) permits a corporation to take its own stock in order to prevent loss upon a debt previously contracted without the usual

approval of the holders of three-fourths of the outstanding stock. In Vermont (*General Laws*, tit. 25, ch. 210, sec. 4920) a corporation may acquire its own shares in payment or partial payment of a debt.

Alaska (*Compiled Laws*, ch. 8, sec. 7), California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 9, sec. 336), Idaho (*Compiled Statutes 1919*, sec. 4745), Maine (*Revised Statutes 1930*, ch. 56, sec. 46, as amended public laws 1931, ch. 183), Massachusetts (*General Laws*, tit. 22, ch. 156, sec. 20), Philippine Islands (*Corporation Act*, secs. 44, 45), and West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 34) have statutes to the effect that corporations may forfeit shares for non-payment of calls or assessments. Maine (*Revised Statutes 1930*, ch. 56, sec. 46, as amended *Public Laws 1931*, ch. 183), Montana (*Revised Code 1921*, ch. 7, sec. 5985), South Dakota (*Corporation Laws*, part 17, ch. 1, art. 5, sec. 8807), and Virginia (*Revised Code*, ch. 147, sec. 3807, as amended to 1932) allow a corporation to purchase its shares sold at auction for assessments in default of a bidder. In California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 336) and Idaho (*Compiled Statutes 1919*, sec. 4745) the defaulting shares must be sold at public auction and only in the absence of other bidders may the stock be purchased by the company. Utah (*Corporation Laws*, sec. 913, as amended to 1932) also permits a corporation to purchase its own shares sold at auction for assessments if no one bids the amount of the assessment and its expense. The law requires this stock to be treated as treasury stock.

In Arizona (*Revised Statutes 1928*, ch. 14, sec. 586) a corporation may purchase its shares sold at public auction for non-payment of subscriptions. Massachusetts (*General Laws*, tit. 22, ch. 156, sec. 20) provides that a corporation may take its stock if a judgment against a subscriber is unsatisfied for thirty days.

Statutes of California (*Civil Code* 1931, div. 1, part 4, tit. 1, ch. 10, sec. 342), Indiana (*General Corporation Act 1929*, part 2, art. 5, sec. 37), Kentucky (*Statutes*, ch. 32, art. 1, sec. 558), Maryland (*Annotated Code 1924*, art. 23, sec. 35), Massachusetts (*General Laws*, ch. 156, sec. 46), New Hampshire (*Public Laws*, ch. 225, secs. 54, 55, 56, 57), Ohio (*General Code*, sec. 8623–41), New York (*Stock Corporation Law*, secs. 14, 21, 38, 87, 105), Rhode Island (*General Laws*, ch. 248, sec. 56), and Tennessee (*Public Acts* 1929, ch. 90, sec. 41) permit a corporation to buy out dissenting stockholders in case of radical corporation changes

such as mergers or consolidations. In Maryland, Ohio, and Tennessee, dissenters are paid only if sufficient funds are available or if enough assets remain to satisfy corporate obligations. The uniform business corporation act (Sec. 42–3) states that rights of dissenters must yield to the superior rights of creditors.

According to the statutes of Arkansas (*Corporation Statutes 1931*, ch. 1, art. 4, sec. 24), Alabama (*Corporation Laws*, ch. 274, art. 4, sec. 7003), Delaware (*General Corporation Law*, art. 1, sec. 28), Florida (*Corporation Law 1925*, art. 6, sec. 22), Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended *Laws 1931*, ch. 480), New Jersey (*General Corporation Act 1896*, ch. 185, sec. 29, as amended and supplemented to end of 1932), and Porto Rico (*Private Corporations Act 1916*, sec. 16a) a corporation may reduce its capital stock by purchasing its own shares. The Alabama law is that, after authorization to reduce capital, a corporation may purchase its own shares for retirement but must not pay above par for them. In New Jersey the shares may be purchased pro rata from the stockholders or on the open market. The Rhode Island (*General Laws*, ch. 248, sec. 53, as amended ch. 1735, *Public Laws 1931* and ch. 1941, *Public Laws 1932*) statute provides that a corporation may reduce its capital by retiring treasury shares upon vote of the directors and upon complying with the conditions of the charter or articles relating to retirement. In Ohio (*General Code*, sec. 8623–39) treasury shares not subject to redemption may be retired and stated capital reduced by the directors. Indiana (*General Corporation Act 1929*, art. 1, sec. 6) specifically permits directors to cancel treasury stock.

In Alaska (*Compiled Laws*, ch. 8, sec. 8), California (*Civil Code 1931*, div. 1, part 7, tit. 1, ch. 10, sec. 342), Louisiana (*General Corporation Laws 1928*, sec. 23), Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended *Laws 1931*, ch. 480), and Ohio (*General Code*, sec. 8623–41) a corporation may purchase its own shares subject to redemption or to carry out provisions of its articles authorizing conversion of its shares. The Ohio (*General Code*, sec. 8623–39) statute requires these shares to be carried as treasury stock until redeemed.

California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342) allows a corporation to purchase its own shares in case of merger with another corporation and also permits it to take its own shares when assets of another corporation are distributed.

The Ohio (*General Code,* sec. 8623–41) provides that a corporation may purchase its own shares for resale to stockholders or otherwise when the articles provide that it shall have a right to preëmption when any stockholder desires to sell his shares or on the happening of any event is required to sell his stock.

Several states, including California (*Civil Code 1931,* div. 1, part 4, tit. 1, ch. 10, sec. 342), Colorado (*Annotated Statutes* (*Mills,* 1924)), and Maryland (*Annotated Code 1924,* art. 23, sec. 50, as amended *Laws 1931,* ch. 480), allow a corporation to acquire its own shares by gift or bequest.

In California (*Civil Code 1931,* div. 1, part 4, tit. 1, ch. 10, sec. 342), Louisiana (*General Corporation Laws 1928,* sec. 23) and Ohio (*General Code,* sec. 8623–41) a corporation may purchase its own stock from an employee other than an officer or a director under an agreement to repurchase. Both Louisiana and Ohio permit a company to acquire treasury stock for resale or allotment to employees.

The statutes of California (*Civil Code 1931,* div. 1, part 4, tit. 1, ch. 10, sec. 342) and Ohio (*General Code,* sec. 8623–41) make it legal for a corporation to purchase its own stock for the purpose of avoiding the issuance of or to eliminate fractional shares.

As early as 1850 the legislature of Georgia (*Penal Code 1850,* ch. 9, 6th div., sec. 43) enacted a statute making the purchase by a corporation of its own stock a misdemeanor and subjecting the president and directors to fine and imprisonment for its violation. At present only a few jurisdictions have direct statutory prohibition of the creation of treasury stock through purchase. California (*Civil Code 1931,* div. 1, part 4, tit. 1, ch. 10, sec. 342) prohibits but allows many exceptions, while Kentucky (*Statutes,* ch. 32, art. 1, sec. 544) and Wyoming (*Compiled Statutes,* sec. 5056) forbid purchase but permit a corporation to take its own stock to prevent loss on a debt previously contracted. However, such stock must not be held for more than one year.

Germany does not permit a corporation to purchase its own shares, except to make possible the amortization of shares as provided in the articles (*Commerce Code,* art. 266). In England the 1929 companies act (19 & 20 Geo. V, ch. 23, sec. 45) by implication forbids a company to purchase its own stock.

National banks are expressly prohibited from purchasing or holding their own shares except where necessary to save loss on debts previously contracted in good faith. This stock must be

sold within six months, at public auction if necessary, or the bank may be dissolved (12 U. S. C. A, sec. 83; 1 *Mason's Code*, tit. 12, sec. 83).

The general corporation statutes of Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) prohibit banks, trust companies and life-insurance companies from purchasing their own stock, while the corporation laws of West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 39) provide that banks must not purchase their own shares. Most of the states have similar provisions in their banking laws.

The statutes of Alaska (*Compiled Laws*, ch. 8, sec. 8), Arkansas (*Corporation Statutes 1931*, ch. 1, art. 1, sec. 7), Colorado (*Annotated Statutes* (*Mills*, 1924)), Delaware (*General Corporation Laws*, art. 1, sec. 19), Florida (*Corporation Law 1925*, art. 4, sec. 8), Indiana (*General Corporation Act 1929*, part 2, art. 1, sec. 3), Kentucky (*Statutes*, ch. 32, art. 1, sec. 544), Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended *Laws 1931*, ch. 480), Michigan (*General Corporation Laws 1931*, sec. 10), Nevada (*General Corporation Laws 1925*, sec. 9, as amended 1931, 420), North Dakota (*Compiled General Laws*, ch. 12, sec. 4531), Ohio (*General Code*, sec. 8623–41), Oklahoma (*Compiled Statutes 1921*, sec. 5320), South Dakota (*Corporation Laws*, part 17, ch. 1, art. 2, sec. 8777), Tennessee (*Public Acts 1929*, ch. 90, sec. 12), Utah (*Corporation Laws*, sec. 913, as amended to 1932) and West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 39) specifically state that a corporation may hold its own shares. According to the statutes of South Dakota (*Corporation Laws*, part 17, ch. 1, art. 2, sec. 8777) a corporation may hold treasury stock if authorized to do so by a resolution of the stockholders or by their unanimous consent in writing. In Vermont (*General Laws*, tit. 25, ch. 210, sec. 4920) treasury stock is not held by a corporation but is held in the name of trustees for the corporation and must be disposed of as soon as possible without loss or within five years. Utah (*Corporation Laws*, sec. 913, as amended to 1932) permits treasury stock to be held according to the corporate by-laws and if there are no by-laws such shares are held subject to the control of the board of directors.

In Montana (*Revised Code 1921*, ch. 7, sec. 5986), North Dakota (*Compiled General Laws*, ch. 12, sec. 4583), and South Dakota (*Corporation Laws*, part 17, ch. 1, art. 5, sec. 8808) the legal title to treasury stock is in the corporation and is subject

to the control of the stockholders, who may dispose of it as they see fit or according to the by-laws of the corporation. Alaska (*Compiled Laws*, ch. 8, sec. 7) permits treasury stock obtained by forfeiture to be reissued and subscriptions taken therefor, as in the case of shares not issued or subscribed.

According to the laws of Louisiana (*General Corporation Laws 1928*, sec. 23) acquired shares of a corporation's own stock are considered to be treasury stock until disposed of by sale or reduction of stated capital. The Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended *Laws 1931*, ch. 480) provides that if stock is purchased for retirement such stock has the status of authorized but unissued capital stock and may be retired without the proceedings necessary for the reduction of capital stock, but stock acquired by gift, bequest or purchase and not for retirement may be held or sold or otherwise disposed of from time to time for corporate purposes. The legislative enactments of California (*Civil Code 1931*, div. 1. part 4, tit. 1, ch. 10, sec. 342) state that a corporation's own stock acquired by it is restored to the status of authorized but unissued shares, and stated capital is not reduced thereby. If the articles prohibit reissue, the authorized number is reduced to the extent of the shares so retired.

The California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342) statutes provide that when a corporation purchases its own stock the earned surplus is reduced by an amount equal to the purchase price thereof.

When a corporation acquires its own shares in Connecticut (*Revised Statutes 1930*, ch. 191, sec. 3423) the president and treasurer within six months must file a certificate with the secretary of state giving the number of shares acquired.

In Rhode Island (*General Laws*, ch. 248, sec. 53, as amended ch. 1735, *Public Laws 1931* and ch. 1941, *Public Laws 1932*) the capital of a corporation is the amount of the assets up to the amount of the par value of outstanding shares, including treasury shares having par value, plus consideration received, including treasury shares. The statutes of this state provide that treasury shares shall not be included in assets when the assets of a corporation are computed. Stated capital includes treasury shares in Ohio (*General Code*, sec. 8623–37).

According to the Maryland law (*Annotated Code 1924*, art. 23, sec. 50, as amended laws 1931, ch. 480) the purchase by a corporation of its own stock does not release the liability of the

holder of stock not paid for in full, unless the assets of the corporation remaining immediately after such release shall not be less than the debts of the corporation plus the amount of its issued capital stock.

Treasury stock has no dividend rights according to the statutes of California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342), Massachusetts (*General Laws*, tit. 22, ch. 156, sec. 20), and West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 38). The laws of Massachusetts (*General Laws*, tit. 22, ch. 156, sec. 20), Montana (*Revised Code 1921*, ch. 7, sec. 5985), North Dakota (*Compiled General Laws*, ch. 12, sec. 4582), South Dakota (*Corporation Laws*, part 17, ch. 1, art. 5, sec. 8807) and Utah (*Corporation Laws*, sec. 913, as amended to 1932) are to the effect that no dividends shall be paid on stock forfeited for non-payment of subscriptions or assessments. All dividends are apportioned among the outstanding stock. Louisiana (*General Corporation Laws 1928*, sec. 26) prohibits dividends arising from profit on treasury stock before resale. Ohio (*General Code*, sec. 8623–4) permits the corporate articles to authorize the directors to fix or to alter the dividend rate on treasury stock.

Most of the states which allow a corporation to acquire its own stock prohibit the voting of this stock either directly or indirectly.

Arkansas (*Corporation Statutes 1931*, ch. 1, art. 1, sec. 7), California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342), Florida (*Corporation Law 1925*, art. 4, sec. 8), Idaho (*Compiled Statutes 1919*), Louisiana (*General Corporation Laws 1928*, sec. 32), Montana (*Revised Code 1921*, ch. 7, sec. 5986), Nevada (*General Corporation Laws 1925*, sec. 9, as amended 1931, 420), New Jersey (*General Corporation Act 1896*, ch. 185, sec. 38, as amended to end of 1932), North Dakota (*Compiled General Laws*, ch. 12, sec. 4583), South Dakota (*Corporation Laws*, part 17, ch. 1, art. 3, sec. 8808), Tennessee (*Public Acts 1929*, ch. 90, sec. 12) and Utah (*Corporation Laws*, sec. 885, as amended to 1932) have statutes to the effect that treasury stock must not be counted as outstanding for stockholders' quorum or voting purposes. A majority of the remaining shares is a majority for purposes of voting at all stockholders' meetings.

Arkansas (*Corporation Statutes 1931*, ch. 1, art. 1, sec. 7), Delaware (*General Corporation Law*, art. 1, sec. 19), Indiana (*General Corporation Act 1929*, part 2, art. 1, sec. 3), Florida

(*Corporation Laws 1925*, art. 4, sec. 8), Michigan (*General Corporation Laws 1931*, sec. 10), Nevada (*General Corporation Laws 1925*, sec. 9, as amended 1931, 420), Rhode Island (*General Laws*, ch. 248, sec. 5), Tennessee (*Public Acts 1929*, ch. 90, sec. 12) and West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 39) have statutes providing that corporations may sell and transfer their own shares which have been acquired. The laws of Alaska (*Compiled Laws*, ch. 8, sec. 8), Maine (*Revised Statutes 1930*, ch. 56, sec. 46, as amended *Public Laws 1931*, ch. 183), and Louisiana (*General Corporation Laws 1928*, sec. 23) state that a corporation may sell its treasury stock, while the statutes of North Dakota (*Compiled General Laws*, ch. 12, sec. 4531), Oklahoma (*Compiled Statutes 1921*, sec. 5320) and South Dakota (*Corporation Laws*, part 17, ch. 1, art. 2, sec. 8777) merely provide that a corporation may transfer such stock. In South Dakota this action requires a resolution of the stockholders or their unanimous consent in writing. Maryland (*Annotated Code 1924*, art. 23, sec. 50, as amended laws 1931, ch. 480) permits a corporation to sell or otherwise dispose of treasury stock for corporate purposes when the stock was not acquired for retirement. Utah (*Corporation Laws*, sec. 913, as amended 1932) allows a corporation to dispose of its treasury stock according to its by-laws or, if these are lacking, according to the wishes of the board of directors. In Kentucky (*Statutes*, ch. 32, art. 1, sec. 544), Vermont (*General Laws*, tit. 25, ch. 210, sec. 4920) and Wyoming (*Compiled Statutes Annotated 1920*) the selling of treasury stock is mandatory.

Let us now consider the selling price of treasury stock. Unless otherwise provided in the articles the board of directors may fix the price in Alaska (*Compiled Laws*, ch. 8, sec. 8), California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342), Delaware (*General Corporation Laws*, art. 1, sec. 27), Indiana (*General Corporation Act 1929*, Art. 1, sec. 6), Louisiana (*General Corporation Laws 1928*, sec. 23), Ohio (*General Code*, sec. 8623–18), and West Virginia (*Corporation Laws 1930*, ch. 31, art. 1, sec. 40). In Louisiana (*General Corporation Laws 1928*, sec. 23) the price must not be less than the price paid when the stock was purchased by the corporation. According to the laws of Vermont (*General Laws*, tit. 25, ch. 210, sec. 4920) the trustees holding treasury stock for a corporation must sell such stock without loss if they can do so. Oklahoma (*Compiled Statutes*, sec. 5320)

and South Dakota (*Corporation Laws*, part 17, ch. 1, art. 2, sec. 8777) allow the stockholders to set the price.

California (*Civil Code 1931*, div. 1, part 4, tit. 1, ch. 10, sec. 342) requires that the consideration received when treasury stock is sold shall be added to stated capital or paid-in surplus.

No shareholder has a preëmptive right to subscribe for shares held by a corporation as treasury stock, according to the statutes of Louisiana (*General Corporation Laws 1928*, sec. 28), Michigan (*General Corporation Laws 1931*, sec. 31) and Ohio (*General Code*, sec. 8623–35).

So far as I have been able to determine, Hawaii, Iowa, Kansas, Minnesota, Mississippi, Nebraska, New Mexico, North Carolina, Oregon, Pennsylvania, South Carolina, Texas, Washington and Wisconsin have no express provisions applicable to treasury stock in their general corporation statutes.

California, Louisiana, Maryland, Michigan, Nevada, Ohio and West Virginia recently have revised or rewritten their general corporation statutes, and they now have comprehensive and fairly harmonious provisions with respect to acquiring, holding and selling treasury stock which apparently meet the needs of present-day business. However, more than half of our jurisdictions have sketchy and inadequate statutory laws relative to treasury stock, while the legislative enactments of nearly a third of our states and territories contain no reference to this subject. It is hoped that future legislation in these jurisdictions will follow the trail blazed by the more enlightened states in the modernization of their general corporation statutes.

Brewery Accounts

By F. W. Thornton

With the return of the manufacture of malt liquor there will be a recrudescence of brewery auditing. The younger generation of accountants has little practical knowledge of such accounts—that, perhaps, is not to be deplored. While the accounting for manufacture will remain essentially unchanged, the accounting for selling and distribution is apt to be quite different from that of twenty years ago, when accounting with customers was complicated by consideration of large loans to saloon keepers, bad debts, unclassifiable payments for the benefit of customers, donations and purchases of tickets from reformers, ward politicians, police, firemen, customers, Sunday schools and others and unjustifiable exactions of customers, masquerading under the pretence of allowances, for sour beer and many other matters having little to do with the art of brewing. The brewery, especially the small local brewery, was looked upon as an institution upon which to sponge.

The accounting for manufacture is simple. Production of beer is accounted for on a "process" basis. Separate brewings are not separately costed and they do not entirely retain their physical identity. Some mixing occurs. All beer of similar age and quality is consolidated in the accounts. Upon setting a brew the brewmaster reports materials taken. The quantity brewed is shown by certain marks in the measured container and under regulations that may probably be revived the brewery must at once take up in a register prescribed by the revenue authorities the barrelage brewed, for all of which there must be account.

The materials so taken are charged to a manufacturing account. Labor, manufacturing expenses and depreciation are also charged to the manufacturing account, and at the end of the month the account is cleared, liquor stock being charged with the entire amount brewed, even including beer that has been set to brew but is not finished. This introduces a small error: liquor not finished is taken into stock as finished beer. The reason for this is that the brewery accounts are brought to agreement with the register prescribed by the government. There is an offset which roughly neutralizes this error.

When a brewing was set and the quantity brewed registered an allowance for loss by evaporation, evolution of Co_2, waste and

leakage was made; this allowance so far exceeded usual losses that a surplus of actual beer over the book inventory accumulated. When it had accumulated to a certain extent it was the custom for breweries voluntarily to take it up in the government register and on the books.

Recent figures published by *The American Brewer* show alcoholic content of pre-prohibition brands of American lager as varying from 3.84 per cent. alcohol for Budweiser to 2.66 per cent. for Weiss Bier. The amount of unfermented extract is quite as important as the percentage of alcohol. Some foreign malt liquors contain:

Strong English ale.	6.78	per cent. alcohol	6.23	per cent. extract
Dublin Stout, best.	6.78	do	7.90	do
German—Tivoli.	5.31	do	4.20	do
do Pilsen.	3.29	do	3.64	do

The more celebrated brands of American beer contained less alcohol and less extract than most of the product of smaller and less known breweries.

Some wild statements as to content of fermented liquors are current; even 20 per cent. alcohol is mentioned. It is extremely difficult, even with the best malt, to obtain more than 14 per cent. beer. With the richest grape juice up to 17 per cent. has been obtained, but with difficulty.

The quantity of alcohol producing material needed per barrel to produce the given percentages of alcohol in lager beer, plus a satisfactory proportion of unfermented carbohydrates and albuminoid extract, is from one and one quarter bushels to one and one half bushels of malt or its equivalent. A bushel of malt is 34 pounds; if entirely fermented it should produce approximately 11½ pounds of alcohol, but little more than half of that amount is actually produced, the remainder of the material being left as unfermented extract and "brewers' grains," which is the insoluble residue of the malt.

Pre-war experience of cost of materials indicates that total cost of all material, including hops and sundries, will not exceed $1.20 to $1.50 a barrel. Manufacturing cost, including refrigeration should not exceed 65 cents. Distribution and selling expenses under the new laws can not be forecast.

It thus appears that the primary cost of manufacture will be a minor part of the cost of beer delivered at the brewery door. Taxes imposed will not be less than $6 a barrel. In this country

no attempt has been made to tax malt liquor according to its strength, but in England tax is levied on the strength of the wort from which the ale is brewed. If, without change in the amount of tax, the addition of 50 cents a barrel to the cost of materials would suffice to change a poor beer to a very good one there would seem to be an inducement to manufacture strong beer as soon as the law permits. At present the cost of materials promises to be not much more than 15 per cent. of the total cost including tax. Then one wonders if under the income-tax law it will be proper to deduct from your income the tax paid on the beer you drink.

Before prohibition, costs were something like these:

Nominal sale price per barrel, $8.00
Discount allowed 25 per cent. to 40 per cent.

Cost:		
Materials	$1.00	
Manufacture	.60	
Delivery	.50	
Selling, including bad debts, loans, and various allowances	1.20	
General expenses	.20	
Excise tax	1.00	
	$4.50	$4.50
Discount	3.20	2.00
Profit	.30	1.50
	$8.00	$8.00

The accounting was most largely concerned with the accounts of customers. Breweries made large loans to customers to equip saloons with bar fittings, pianos, pool tables and other furnishings and for stocks of cigars and distilled liquors. Few saloon keepers ever paid any real money on these loans, but upon their paying for beer a part of the discount was applied against the loans, often without the knowledge of the saloon-keeper. Thus, the brewery may have deducted 35 per cent., allowing a deduction of 25 per cent. on the payment and applying the remaining ten per cent. on the loan.

Loans were made again when new fixtures were needed. If another brewery attempted to take the trade of a customer the loans were the means of retaining the business; any interloper must pay or assume the loans before the saloon-keeper could leave the old brewery. As much as $4.50 a barrel of annual trade has been paid to take over the trade of saloons.

Sometimes loans were made for strange purposes. A relative or friend of a customer was arrested—the brewery was called upon. A saloon-keeper broke his leg—the brewery paid the hospital. A saloon-keeper's wife wanted a fur coat—on some pretext a loan was obtained from the brewery. In a specific case in New York a saloon-keeper's wife called upon a brewery manager saying that she needed help. The manager courteously said that the brewery would be glad to help if possible; what was the trouble? She replied: "Well, it's a week Wednesday when my husband came home one night—no it was three in the morning"—here the words began to gain speed—"three in the morning and who knows what company he keeps and him not half sober, and that's no time for a married man to be coming home not to speak of the whiskey and I told him it was no time for him to be coming home and told him what I thought of him and while I was telling him my artificial teeth flew out and him staggering about stepped on them and they was broken and now I want the brewery to lend me the cost of a new set." As the lady reached her peroration the rapidity of her utterance was such that the accident to the teeth seemed to have been inevitable. She got the loan. No punctuation appears in her speech reported above; punctuation marks represent pauses; there were no pauses.

It is improbable that future arrangements will be such as to permit results like that. There was trouble over the collecting; the worse class of saloons would not pay until the collector had spent a good percentage of the money over the bar; the collectors drank too much.

Licences were paid for by the breweries but made out in the names of the saloon-keepers, who had to pay for them by weekly or monthly instalments. These payments were generally made promptly. The reason for the practice was that any violation entailing forfeiture of licence was effective not against the premises but against the licence-holder, and if the brewery were the licensed party a violation by one saloon-keeper might cause cancellation of all the licences of the brewery.

It will be seen that brewery accounts, apart from the manufacturing accounts, may bear little resemblance to those of twenty years ago. Bottled beer is likely to be sold more largely, and new methods of accounting will have to be developed in accordance with the laws that will govern the trade. Losses of bottles were so great in the past that bottling was not very profitable.

If bottle trade is to grow, some method of preserving bottles from destruction will be needed.

All percentages given here are by weight; percentages by volume are unscientific and rather silly. If we mix 50 volumes of water with 50 volumes of alcohol we do not get 100 volumes of the mixture; there is condensation, and this condensation is not directly proportionate to the percentage of the constituents nor is it constant over variations of temperature.

Finally it may be said that fairly competent accountants need not fear to undertake audit of brewery accounts. If they have had a little experience of cost accounts they will find the manufacturing accounts exceedingly simple and the remainder of the work will probably not differ much from the accounting for other selling enterprises. In the past the accounting of breweries has been distinguished for frankness and honesty. Holding companies may have misrepresented some facts in their accounts, but the accounts of operating brewing companies have been among the best of corporate accounts.

Accountants have been known to verify physically the quality and condition of the inventories. That, of course, is to be mildly deprecated.

The Accounts of an Oil Company *

III

By H. G. Humphreys

The articles on this subject which have appeared in previous issues of The Journal deal with properties and income in general terms. The details are yet to be discussed. However, before proceeding with such discussion certain forms of records might be briefly considered.

Let it be assumed that the accounting company has adopted the following described cash-journal and auxiliaries:

Cash-journal
Month and year
Date
Voucher No.
Name and particulars

	Columns	
1. Cash	Dr. & Cr. Columns	Detailed in auxiliary records
2. Accounts receivable		
3. Accounts payable		
4. Material in warehouses		
5. Deferred accounts		
6. Properties		
7. Operations and trading		
8. General ledger		
Account no.		
Title of account		

Auxiliaries 1 to 5

No explanation of these auxiliaries is necessary in this article.

Auxiliary 6 Property record
Auxiliary 7 Operating and trading record

A separate sheet is assigned to each lease or other unit. This sheet has 14 period columns—one for the previous year's total and accumulated total from inception, one for transactions of each month of the current year and one for the current year's total and accumulated total from inception to date. The heading contains essential descriptive detail in each case, respectively, and the

* The first article in this series appeared in The Journal of Accountancy for February, 1933. The second appeared in the March, 1933, issue.—Editor.

vertical classification corresponds to the company's card of accounts.

The entries in columns 6 and 7 of the cash-journal are analyzed on sheets designed for that purpose (written or printed from punched cards), providing for direct voucher reference. The monthly net totals of analysis sheets are carried to the respective sheets in the auxiliary record.

General Ledger 8

At the close of each month a summary of the month's transactions of columns 1 to 7 of the cash-journal is carried to column 8, general ledger, in convenient form for posting. The cash-journal entries for the month are thus balanced in the latter column. All direct postings to the general ledger (column 8) are fully described or give reference to an auxiliary containing full description. Having essential detailed information thus available direct from the books, budget forecasts, comparison of various costs and other determinations are facilitated. Such a set-up is made to order for the independent auditor.

. . . . .

Coming to the details of properties, reserves and income, by departments, it may be stated that the greatest volume of transactions is applicable directly to units (leases, for example). As to the remaining volume, the greater part may be allocated directly to operating departments as a whole, leaving a remainder (which would probably not exceed five per cent. per annum on the average depreciated investment) to be apportioned over operating departments on the basis of average depreciated investment. Having all profit-and-loss figures of every description, excepting non-recurring income, thus spread over operating departments, one can now safely consider costs. For example, the average over-all cost of producing a barrel of crude oil for a given period is found to be (a) lease operating costs, district costs (apportioned on "well" or other basis), direct departmental costs, depletion, development costs, depreciation, amortization of undeveloped investments, canceled leases and proportion of unallocated general expenses, less earnings other than crude oil, divided by (b) barrels of crude oil produced during the period. While it is true that a producing company without undeveloped acreage to draw from to replenish declining production is on the way out of the produc-

ing business, it is also true that the cost of carrying such acreage can not be omitted from the calculation of the cost of producing oil, if the company is to play on the safe side.

Oil and Gas Properties

A volume might be written explanatory of various kinds of oil interests. To be of real value, the volume should contain a complete correlation, by typical cases, of the grant or assignment, operating agreement, a forecast of costs and earnings and a different picture to represent an account of "actual" transactions—both from the grantor or assignor and grantee or assignee points of view. For present purposes, the following general descriptions are submitted:

Land in fee—as the name implies, represents the title in fee simple to the surface as well as to the mineral and water rights of a given property.

Royalty—an interest retained by fee owner on granting oil and/or gas rights in a given property—such interest being, say, one-eighth of the oil and/or gas saved, without charge for development and operating, but subject to charge of various state and local taxes.

Working interest—oil and/or gas rights (say, seven-eighths) originally granted by the fee owner. The holder of a working interest is privileged to enter upon the premises and explore for and produce oil and/or gas at his own expense and risk, but without damage to the rights remaining with the fee owner or his assigns.

In many instances the working interest is owned by several parties, as the result of assignments subsequent to the original grant, one of whom operates the property.

The Mid-continent Oil and Gas Association, Tulsa, Oklahoma, under date of April 11, 1930, issued a bulletin describing a "*Proposed Uniform Accounting Procedure on Joint Interest Leases.*" The groundwork of this procedure was laid by the Petroleum Accountants Society of Oklahoma. The exhibit "A" given in the bulletin mentioned may be made part of an operating agreement. It is too lengthy to be repeated verbatim in this article, but its perusal is recommended to readers who desire more information as to the normal and special transactions of joint leases.

Over-riding royalty—an interest that originates in the assignment of rights in a working interest, whereby the assignor retains

a part of the working interest without bearing any part of the costs of development and operation. Its rights are limited to the express terms of the contract. For example:

(a) Assignor might sell, assign, transfer and set over unto assignee, subject to reservations, all of assignor's right, title and interest (say, seven-eighths) in and to a certain oil and gas lease; assignor reserving unto himself (1) the said lease and all rights thereunder so far as the lease covers all the land which lies below, say, 3,000 feet, and (2) an interest of one-seventh of seven-eighths of all the oil and gas saved from the land above 3,000 feet.

Books.—Ordinarily, assignor's oil would be run for his account, the purchasing company paying him direct the proceeds of his oil, less production tax withheld for the state. His share of gas would be paid him by the assignee.

(b) For $50,000 down cash payment, assignor might sell, assign, etc., subject to reservations, all of its right, title, etc. (say, seven-eighths); assignor reserving a fractional interest in the first oil and gas saved, to be credited to assignor at the sale price thereof until the credit should equal, say, $50,000. This credit is usually known as an oil bonus. Fractional interest might be as follows:

One-sixteenth of oil and gas saved so long as oil production would not exceed 500 barrels a day.

One-eighth so long as oil production should exceed 500 barrels a day.

Books.—Oil, in this case, would probably be run for the account of assignee who, in turn, would account to the assignor for latter's share of the proceeds, according to contract, until such credits to assignor should equal the sum of $50,000—oil bonus.

A difficult question of depletion might arise here. The assignee has paid $50,000 initial cash bonus for the lease and bears all costs of development, equipment and operations, receiving earnings in the sum of the proceeds from seven-eighths of the oil and gas saved, less the amount of earnings due assignor. If such earnings to assignor were sufficient to pay off the $50,000 oil bonus during the first fiscal year of the assignee, all well and good; but, if production were to be in such quantity and/or at such prices that the oil bonus of $50,000 would not be liquidated in several years, on what basis should the assignee deplete his initial cash bonus of $50,000? The oil reserves of the entire seven-eighths working interest may be acceptably estimated, but, as the credit

to assignor consists of unknown barrels at unknown prices, the assignee's portion of the seven-eighths oil reserve estimate for depletion purposes is indeterminable. The popular and probably erroneous way of computing the annual amount of depletion of assignee's lease cost ($50,000) is to consider the payments on oil bonus as additional lease cost, earnings being credited in like amount, per contra. The lease cost (initial cash bonus) plus subsequent payments on oil bonus are then covered by reserves in ratio to the decline of the entire seven-eighths oil-reserve estimate. If the oil bonus is merely a lien on the oil in place, the popular procedure mentioned is correct. If, however, the oil bonus represents an over-riding royalty—an economic interest in the oil in place—then the assignee should deplete on an oil reserve basis of thirteen-sixteenths when paying on a one-sixteenth basis and on an oil reserve basis of three-fourths when paying on the one-eighth basis. And should the property be in a state in which ad-valorem tax is laid on producing property, the assignee here would pay such tax on the same proportion as the run of oil, viz.: thirteen-sixteenths or three-fourths of the oil in place.

Carried interest—an interest retained by the assignor on assigning rights in a working interest. The carried interest participates in the excess of earnings over the operating costs plus development and equipment costs and, in some cases, plus leasehold cost to assignee, as may be provided in the contract. For example: (a) Assignor might assign all of his title in a certain lease upon a down cash payment of, say, $10,000, subject to reservation, assignee to retain the proceeds of all of the oil and gas saved until the total proceeds should equal the cost of development, equipment and operating (pay-out) when assignor would participate in, say, one-fourth of the net proceeds thereafter, similarly computed.

Books.—Carried interest would receive a complete detailed billing of all transactions from inception. When the pay-out status would be attained, one-fourth of all subsequent development, equipment and operating costs would be charged and one-fourth of all earnings would be credited to assignor. Payments to assignor would be deferred if further development were contemplated. If the pay-out status, as defined in the contract, should not be attained, the entire loss would fall on the assignee.

(b) Assignor might assign title in a lease upon a down cash payment of $250,000, subject to reservations, assignee to retain all of the proceeds and to pay all development equipment and

operating costs, including all taxes; assignor to participate in one-half of the net profits, as shown by the assignee's books.

Books.—The assignor's share of the profits in this instance would be computed thus:

Total gross earnings (proceeds)		$
Deduct:		
Original cash bonus	$250,000	
Development		
Equipment		
Operating		
Administration—portion		
Income tax		
Remainder, say		$29,500
Deduct:		
*Additional bonus	$ 10,000	
Less: income-tax adjustment	500	9,500
Balance		$20,000
Whereof:		
*One-half to assignor		$10,000
One-half to assignee		$10,000

This is the sort of transaction that might originate in a curbstone offer expressed thus:

"Elmer, I don't want to bother keeping books—give me $250,000, you keep the books and send me the details monthly. Then give me one-half of what your net profit may be and I'll let you have the lease."

Partnership accounts

These so called partnerships are sometimes referred to as limited joint ventures. Assuming that each interest represented in a given venture constitutes an economic interest in the oil in place and each such interest is individually liable for all taxes—ad-valorem and/or production tax, income taxes, etc.—then each interest is a separate estate or part.

The operating "partner" keeps the books and renders each non-operating "partner" a complete detailed billing of transactions monthly, to the end that the non-operator may be as fully informed as is the operator as to the costs that are being incurred.

Non-producing investments—general ledger accounts

100. Royalty and lease costs, renewal cost, commission, recording fees, legal-costs
101. Reserve for amortization over terms of leases (leases usually run five years)
102. Subsequent costs, down to production or surrender of lease
    1. Rentals
    2. Exploration
    3. Dry holes, less salvage
    4. Other
103. Reserve for amortization of subsequent costs—(usually 100 per cent. in year in which incurred)

A separate sheet is given to each investment in the auxiliary record, classified horizontally as above—100 to 103. The head of the sheet shows:

Lease name and number
Section, township and range
District, county and state
Acreage
Ad-valorem and/or production tax
Proportion of interests
Term
Date of original grant and renewal date
Renewal provision
Rental provision
Contingent liability—oil bonus or carried interest
Class of lease—commercial or Indian land

Should the investment become productive, the costs, less reserve for amortization, are transferred to producing investment, account 104, the remaining costs being closed to reserves, 101 and 103. If the lease should be canceled, profit-and-loss is charged with the unamortized balance and the remainder is closed to the reserves.

No expenditures against undeveloped leases—rentals, for example—are charged direct to expense. Thus, the gross costs of undeveloped properties are readily available at all times.

Producing investments—general ledger accounts

104. Royalty and unamortized lease costs, intangible development and equipment
1000. Crude oil sales—external
1001. Crude oil sales—internal
1002. Crude oil inventory fluctuation
1003. Gas sales—external
1004. Gas sales—internal

1005. Miscellaneous earnings—external
1006. Miscellaneous earnings—internal
1100. Operating expenses

An auxiliary book is maintained in which a separate sheet is given to each property, having full description of the investment, with fourteen period columns—close of previous year, each month of current year and close of current year. The vertical features are as follows:

Vertical features	Source of entries
Investment Royalty or lease Development Equipment Losses, depreciation and adjustment Less: joint lessee's proportion Company's net investment	Entries to auxiliary are from analysis, by leases, of account 104, items found in column 6 of the cash-journal.
Earnings—barrels Production Oil sales Oil inventory fluctuation Earnings—amount Oil earnings Oil sales Oil inventory fluctuation Gas sales Miscellaneous earnings Total earnings—net to company	Entries to auxiliary are from analysis, by leases, of accounts 1000–1006, items found in column 7 of the cash-journal. Division as between external and internal is made, but it is used for general ledger purposes only. Vouchers are designed to meet the convenience of analyzing.
Operating expenses All labor Transportation Fuel and water Maintenance material Apportioned district expense Miscellaneous Less: joint lessee's proportion Taxes (less-joint lessee's portion) Insurance (less-joint lessee's portion) Total expenses to company	Entries to auxiliary are from analysis, by leases, of account 1100 items found in column 7 of the cash-journal.

If the volume of business justifies the use of machinery, all analyses of investment, earnings and expenses may be made by means of punched cards, which would require the vertical features of the auxiliary to be numbered.

Producing leases—equipment

The auxiliary record gives the entire transactions applicable to equipment, the portion representing outside interests being taken

up in a separate item—joint lessee's proportion. Most companies have a material supervisor through whose hands pass all requisitions for material, to enable him to fill them out of available stock, as far as may be. He then passes the partly filled or entire requisition to the purchasing agent. There is usually more material delivered to a property under development than is actually needed, the surplus material being brought under special control when the lease is equipped. This idle material is reported monthly, or oftener, by the lease foreman to the supervisor. At the close of each accounting period the company's interest in this idle material is transferred by non-ledger entry from investment (properties) to material and supplies (current asset).

A sub-auxiliary book is maintained to analyze equipment and material by job numbers, quantities, description and cost. This sub-auxiliary consists of a number of sheets for each lease, one sheet to each of the following named features:

Rigs and rig equipment	Miscellaneous tools
Tanks	Motors, generators and transformers
Boilers	Separators
Engines	Sucker rods
Powers	Pipe, by sizes
Pumps	Tubing, by sizes
Buildings	Casing, by sizes
Cleaning-out tools	Other equipment

Each item recorded in the sub-auxiliary is fully described, so that a set of sixteen sheets, assigned to a given lease, would serve to control all the equipment and idle material on such lease. A map of each lease is maintained which shows location of equipment—surface and underground.

Material may be transferred from lease to lease within a given district by mutual arrangement between lease foremen. Movement of material between districts, however, is usually done on the order of the supervisor. Material moved is covered by a "transfer," reported to office by transferor and acknowledged by transferee. A transportation ticket (showing distance, time, etc.) is sent to office with transfer, and the two are there compared.

The audit of material usually covers an entire district, so that shortages and overages between leases, due to field men's failure to issue transfers, usually counterbalance reasonably within the district. Differences not accounted for by inventory are charged, after approval, to losses, depreciation and adjustments (a feature

hereafter described) or to inventory adjustments, according to the circumstances of each case.

It often happens that the initial well is drilled and equipped free of cost to the outside interests, subsequent development costs being borne proportionately. The entire cost borne by the company on the free well is charged, of course, to development and equipment. In the equipment sub-auxiliary record a complete memorandum is kept of the cost of drilling and equipping the free well. In order to determine that the outside interests, say one-half, have been charged their full contractual share of investment costs, a summary is made as follows:

Total development and equipment cost......................	$
Less: memorandum cost of free well........................	
Remainder..	$
Whereof one-half is joint lessees' proportion..................	$

If the free well were to be non-productive, the material would be the property of the operator. If, however, the well "came in" a producer, joint lessees could have a share in the material value. The following account will illustrate the point:

Assessment control Dr. (Cr.)

	General ledger			Extract—auxiliary			Sub-aux.
	Personal accts.	Cash or equiv.	Equipment	L. D. & A.	Jt. lessee proportion	Company proportion	Memorandum
1.	Free	($30,000)	$30,000		Free	$30,000	$30,000
2.	$15,000	(30,000)	30,000		($15,000)	15,000	
3.	(5,000)	10,000	(10,000)		5,000	(5,000)	
4.			(5,000)	5,000			
5.			(2,000)	2,000			
6.	(2,500)	5,000	(5,000)		2,500	(2,500)	
7.			(38,000)	38,000			
8.				$45,000	($7,500)	$37,500	
9.						($37,500)	
10.	($7,500)				$7,500		
11.		$45,000		$45,000			

1. Well No. 1 free to joint lessee.
2. Well No. 2 cost borne half and half.
3. Transferred from lease at condition value.
4. Depreciation—residue value of transferred material.
5. Material lost.
6. Salvage on abandonment at condition value.

7. Depreciation—residue value of salvaged material.
8. Net investment.
9. Company's reserve for depreciation.
10. Joint lessee proportion—proof.
11. Cost of material unrecovered.

Losses, depreciation and adjustment are chiefly composed of (a) net value of uninsured material actually lost through fire, tornado, etc., (b) cost less proceeds on material transferred from the property, (c) remaining cost standing charged to equipment on abandonment, after giving effect to salvage value. The reserve for depreciation at abandonment is adjusted to agree with losses, depreciation and adjustment (provided the working interest is fully owned), and the depreciation charge to profit-and-loss for the year is debited or credited, per contra. It sometimes happens that the lease has been over depreciated down to the close of the previous year. Should the company own only a part interest, then, on abandonment of lease, the company's reserve for depreciation of equipment would equal losses, depreciation and adjustment less joint lessee proportion, as given in the foregoing "assessment control."

It may be contended that on each transfer or loss of material the reserve should be charged its proper quota. Unfortunately, the proper charge is not easily determinable if the company computes depreciation in ratio to decline of oil reserves. Why depreciate on the straight-line basis when production might continue for any duration from one to fifty years? And there is an advantage in keeping all charges to reserve in suspense (losses, depreciation and adjustment).

There are probably not many carried interests in effect at the present time, but, in view of present economic conditions, this method of trading may become more popular. The carried interest, as has been explained, becomes a beneficiary when the investment, either wholly or in part, has been paid out by earnings. By having complete pure figures in the auxiliaries, settlements with carried interests may be made promptly and accurately, so far as the investment and operating charges apply against earnings. The contract may provide for other charges, such as an administrative allowance.

In order to adjust the reserve for depreciation on the balance-sheet at the close of the accounting period, a percentage of losses, depreciation and adjustment (equal to the percentage of reserve to

total equipment—computed as to each property) is credited to cost of properties and charged to reserve by non-ledger entry.

Producing investments—general ledger accounts

Account		
105.	Reserve for depletion and depreciation on cost	For income-tax purposes only
106.	Additional reserve for depletion under section 114 (b) (3) 1932 revenue act	For income-tax purposes only
107.	Additional depletion—27½ per cent. basis over cost basis	For income-tax purposes only
1101.	Canceled leases	
1102.	Depletion of leasehold	
1103.	Development (depreciation)	
1104.	Depreciation of equipment	

Section 114 (b) (3) of the federal revenue act of 1932 reads:

"In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, . . . Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Three simple examples of the application of this rule follow:

	1	2	3
Gross income	$100,000	$100,000	$100,000
Operating expense	10,000	10,000	10,000
Development	10,000	10,000	20,000
Depreciation	10,000	10,000	20,000
Proportion of overhead	2,000	2,000	2,000
Total deductions	32,000	32,000	52,000
Net income	68,000	68,000	48,000
50 per cent. of net income	34,000	34,000	24,000*
27½ per cent. of gross income	27,500*	27,500	27,500
Depletion on cost	20,000	40,000*	20,000
Depletion deductible	$27,500*	$40,000*	$24,000*

Example 3 (assumed to represent the first year's operation of a given lease) has a cost depletion of $20,000, but a deductible depletion of $24,000. The law seems to recognize the estate value of an oil interest as being possibly in excess of cost, such value being indeterminable at the commencement of operations.

From year to year some measure of this value appears. (The example under consideration indicates a 20 per cent. present additional value to the estate.) As the result of subsequent operations, this value would vary according to the variations of three factors—oil produced, gross income and deductions. The following is given to show the present additional value:

	Cost	Additional* value
Basic oil reserves—barrels	400,000	400,000
Produced in first year—barrels	80,000	80,000
Leasehold cost	$100,000	$20,000*
Unit rate of depletion	.25	.05
Amount of depletion	20,000	4,000

In the accounts additional depletion would be charged to account 107 and credited to account 106. These accounts might be kept in a private ledger, together with memoranda of non-taxable and non-deductible items, etc. All this would be done for the purpose of providing means for a ready reconciliation between published figures and income-tax figures.

It appears that, subject to proper expense deductions, at least in the case of a producing property, the following gross income is entitled to the benefits of section 114 (b) (3):

To fee owner
Cash bonus received (advanced royalties) and subsequent receipts (deferred royalties).

To over-riding royalty
Cash bonus and oil bonus received.

To carried interest
Cash bonus, and proportion of gross earnings after the lease has paid out according to contract.

To working interest
Gross earnings and, should a part of a working interest be sold, bonus realized from sale of part interest.

The allowances for depletion suggested in the foregoing are, in some instances, the subjects of court cases now pending.

For federal income-tax purposes, depletion on cost of a leasehold is determined by computing the reserve against investment in ratio to the decline, through production, of estimated oil reserves. Intangible drilling cost may be entirely covered by reserve in the year in which incurred or on the same basis as lease-

hold. Depreciation may also be on the same basis as that of leasehold or on any other reasonable basis that may be regularly used by the company.

Some concerns do not amortize non-producing investments in accordance with the procedure previously mentioned, although they capitalize all costs of every description. If the lease should be surrendered, they write off the accumulated cost at that time. Should the lease become productive, the accumulated cost to date is transferred to producing investment, to be returned through depletion. For balance-sheet purposes, a surplus reserve is usually created to bring non-producing investments within the safe zone of value at the balance-sheet date.

The matrices used for determining the depletion charge and also the status of each lease at the close of each year of its active life may be summarized as follows:

X Y Z Lease

Oil reserve at basic date—estimated barrels
Production by years—actual barrels
Production accumulated—actual barrels
Balance of oil reserves—estimated barrels

Gross earnings by years—oil, gas and sundries
(1) Gross earnings accumulated
Operating expenses by years
(2) Operating expenses accumulated
Operating earnings by years
Operating earnings accumulated
Depletion and depreciation by years:
Depletion of leasehold
Depreciation of intangible drilling cost (100% or less)
Depreciation of equipment
Total depletion and depreciation by years
(3) Depletion and depreciation accumulated
Net earnings by years
Net earnings accumulated

Investment
Leasehold cost
Intangible development cost
Equipment cost
Total by years
(4) Total accumulated
(3) Reserves accumulated
Investment less reserves

Pay-out status
(4) Investment accumulated
(2) Operating expenses accumulated
Total expenditures
(1) Gross earnings accumulated
Gross earnings in excess of expenditures

Depletion (a) cost of leasehold less previous reserve at close of year, divided by (b) balance of oil reserves at beginning of year gives (c) unit rate, which multiplied by (d) barrels of production for the year, gives (e) amount of depletion for the year. The oil production of each lease must be kept separate until run to purchaser.

Oil reserve is computed as to probable recovery from the first well. The reserve is afterwards built up, well by well, until the entire lease has been drilled.

Oil and gas properties—Conclusion

Accounts prepared as outlined in the foregoing paragraphs would show the balances of the following general ledger accounts, pure details of which would be found in the auxiliaries, divided by individual units of investment:

Non-producing investments
- 100. Royalty and lease costs, etc.
- 101. Reserve for amortization of leases
- 102. Subsequent costs
- 103. Reserve for amortization of subsequent costs
- 1101. Canceled leases

Producing investments
- 104. Royalty and unamortized lease costs, etc.
- 105. Reserve for depletion and depreciation on cost
- 1000. Crude oil sales—external
- 1001. Crude oil sales—internal
- 1002. Crude oil inventory fluctuation (lease stock tanks)
- 1003. Gas sales—external
- 1004. Gas sales—internal
- 1005. Miscellaneous earnings—external
- 1006. Miscellaneous earnings—internal
- 1100. Operating expenses
- 1102. Depletion of leasehold
- 1103. Development—depreciation
- 1104. Depreciation of equipment

In one of the later articles of this series departmental expense, general expense and internal facilities (water stations, telephone, etc., etc.) will be described.

[The fourth article of this series is to appear in THE JOURNAL OF ACCOUNTANCY for July, 1933.—EDITOR.]

Appraisal Accuracy and the Accountant

By Reinhard M. Fischer

Appraisal has fallen upon evil days. Many valuations are viewed with suspicion by bankers, accountants and investors with sad experiences, who are unlikely soon to forget an unsatisfactory record of past performance. But values are undergoing radical changes under the influence of fluctuating levels of commodity prices, inadequacy of plant facilities due to restricted use and relentless technical progress, causing obsolescence. Whatever justice may be in the indictments of persons or organizations, appraisals of the fixed assets of industrial and commercial enterprises will be an urgent need of the near future and they should command increased attention by management and the accountant, when the task of re-stating property accounts is undertaken with the return of stabilized business conditions. A better understanding of the basis of information, usually contained in appraisal certificates, summaries and inventories, will materially assist in avoiding some of the errors of the past by eliminating haphazard estimates, lacking in method and consistency.

This does not imply that the accountant should attempt a detailed check of appraisals, because they are technical in nature and require engineering knowledge, specialized records and organization, not generally available to the accounting practitioner. Yet he should insist on a definite answer to the test of accuracy of figures, which so often form an important portion of capital structure. He will then be surprised to learn how little information is readily available, demonstrating the failure of the average appraiser to give sufficient thought to the matter. This is in marked contrast to other branches of engineering. The designer of a structure can tell off-hand the safety factors used in his computations. Of course, economics is not an exact science; but the determination of an approximate range of accuracy is not a goal impossible of achievement, provided the findings represent the outcome of methodical and painstaking investigation.

The impression gained from a superficial review of most certificates is that the values shown are 100 per cent. accurate, down to

fractional dollars, even though the total may run into millions. Yet no assumption could be less sensible, as I hope to show by an outline of the great number of hazards to which all such estimates are of necessity subject. It is my contention that it would be preferable to acknowledge given limitations of performance instead of detracting from the value of the information contained in an appraisal by obscuring the sources of potential discrepancies.

Let me relate a strange happening. A surveyor appears at a street intersection and proceeds to set up his instrument. He seems bent upon unusual precision, judging from the number of observations and readings of auxiliary apparatus for scientific corrections. After spending a good deal of time and effort in this manner, he suddenly tires at the slow rate of progress, and in the middle of the block he starts measurement with a steel tape. Evidently this method does not yield quite the required speed, and so he paces off the remainder, nonchalantly taking only mental note of the estimated distance around an obstruction where the sidewalk is under repair. Yet his conscience awakens as he approaches his goal, so he sets up his instrument with diligence for the last few feet. Now he turns to his tables, slide-rule and calculating machine and in due course presents us with the result of these endeavors—a computed length of 685 feet 7 and $13/64$ inches. Here we probably regain consciousness in a cold perspiration.

A wholly unreal dream, one may say. Yet exactly comparable procedure and findings are accepted every day without comment in most appraisal certificates. Heterogeneous elements of value are often united under the dollar sign without any indication of the range of accuracy inherent in the methods used in ascertaining the figures.

To illustrate the problem I give below an example from actual practice, reproductive costs found in the appraisal of a large gravel plant:

Gravel deposits, including attached business value	$304,800.00
Land	25,400.00
Land improvements	2,648.47
Railroad sidings	40,786.15
Building construction and building fixtures	56,800.75
Machinery and equipment	102,129.78
Marine equipment	237,035.00
Total	$769,600.15

Three widely differing principles are used in producing these figures. The value of the deposits is based on capitalization of expected future income or relative advantages, depending on whether allocated profits or fair royalties were used. In this case inclusion of business intangibles indicates the former method.

Land values are generally comparatives, reconciling opinion and judgment in a confusing range of more or less frequent bid and asked prices. Often transactions in the past or immediate neighborhood furnish no representative standard of measurement, because the specific real estate exists only once under the given conditions of the present, so that there can be no such thing as "reproductive cost."

The remaining classifications are composites, built up by summation of details, which supposedly represent competitive cost of replacing their utility. Generally the various items are extensions of surveyed quantities at a unit cost—for instance 20,000 brick at $10 a thousand—so that accuracy is mainly dependent on how representative quoted market prices are for the case. Physical data can ordinarily be determined within known limits of precision in accordance with time and effort or expense.

A fortunate factor for the accuracy of totals is the averaging of errors. As the number of items in the composite increases, the result becomes more trustworthy. Yet this is only true of independent items within a reasonable range of weighted importance towards the total. Proper grouping would therefore avoid combining a large number of small tools with a few very expensive special attachments to preserve the possibility of judging the consistency and accuracy of the total. If this principle should be more closely followed in the presentation of appraisals, it would be of much help to persons who have only occasional contacts with valuation problems. At present variations of more than 10,000 per cent. between items in one column are a familiar sight, as the example shows, where land improvements represent less than 7/10 per cent. of the figure for deposits. This applies as well to real-estate valuations which throw together large and small parcels of widely differing unit cost.

Returning to the original query—the range of accuracy in the summary figures—let us examine the various property groups in more detail. With few exceptions the largest single item in any appraisal inventory determines the accuracy of the total, so that

in the test the gravel deposits are likely to furnish the desired criterion.

The limiting considerations in this case are the cost of acquiring equivalent but undeveloped gravel acreage or quantities by outright purchase or the right for depletion on the basis of royalty contracts. The physical volume of production is limited by the general layout, plant capacity, shipping facilities and rates and markets. From such indications it may have been concluded that a minimum of $250,000 is assignable to the available quantity under the given conditions, while any value above $325,000 would seem unwarranted, even when discounting future possibilities with the utmost optimism. A range of $75,000 may appear excessive and unusual at first glance, but it is justified in this instance by the hazardous and volatile intangible elements of value, tied to quickly disturbed earning power in this industry. Subsequent events only too often demonstrate the hazard in the estimate of earnings, even where they seem to possess assurance of continuity, judging from past records. Therefore a range of plus or minus 15 per cent. is not at all out of line with conditions of accuracy, unadmittedly prevailing in practice in the valuation of this class of asset, because the inclusion of such factors as management, customer goodwill, fair return on investment in facilities and working capital and the background of local and national business conditions injects a definite uncertainty into informed judgment interpreting these factors and trends. The multiples applying to anticipated earning power must accordingly vary in a wide range, and this in no way discredits the appraiser, who fully understands the circumstances.

The next classification covers two parcels of agricultural land, reserves and protection for the other holdings, the larger one consisting of 150 acres at $120. Prices in a range of from $110 to $135 could as well be justified—yielding a maximum of $20,250, the largest probable deviation would be $2,250. While this is a substantial amount, it is insignificant compared to the uncertainty in the value of the deposits. On the other hand land improvements are separately accounted for at $2,648.47, closely within the range of possible inaccuracy in the land. In turn, their probable precision depends on a quantity survey as well as on unit costs, because the main item here is a dam, forming an embankment created by dredging and filling. Its cubic contents are computed after a somewhat arbitrary decision in regard to a natural grade

line—a questionable point often encountered in valuing excavations and other earthwork. A further problem, frequently presenting complications, is the selection of a proper method of reproduction, cheapest under prevailing local conditions at the date of appraisal, which may differ greatly from those under which the work was originally performed. Whether the dam would be duplicated today by hand labor or with the assistance of excavating machinery and various transportation mediums may cause a substantial variation in the unit cost to be applied, up to 30 per cent.

Railroad sidings can not be approximated closer than plus or minus 10 per cent., with the information ordinarily available. Even under favorable conditions 5 per cent. must be considered a fairly accurate range for building construction estimates with an average amount of detail. These percentages are borne out by the wide discrepancies, often reaching 50 per cent. and more, generally found in the bids of contractors for a given and definitely specified piece of work. While this may be partly due to considerations of activity and availability of men and equipment, the corresponding sacrifice in overhead and profits explains only partly this wide range, which is more frequently the result of difficult estimating problems. These are quite as hard to solve for the appraiser as for the man with continuous specialized experience.

This is no less true, when one considers those classifications where competitive quotations are usually obtained from manufacturers of standardized or special machinery and tools. "Reproductive cost" is generally understood to mean "cost of replaced service and utility," and this injects the necessity of exercising engineering judgment in those frequent instances where obsolescence or inadequacy has decreased the original cost of equipment, rendering equivalent service. Installation costs and the selection of proper labor and transportation rates under given local conditions add to the uncertainties. Substitute materials, products and processes may enter the broad scope of the considerations of the conscientious appraiser.

In the so-called "minor classifications"—plumbing, piping, electric wiring for power and light, ventilating and heating systems, sprinkler systems and other installations found occasionally —the trustworthiness of the appraisal is influenced by the time spent in investigation, accessibility of details or availability of cor-

rect plans and specifications for concealed portions of the equipment as well as familiarity with the peculiar requirements of industries. Some chemical plants in which piping is subject to heavy corrosion may have special lead-lined fittings and runs, and if this is not properly recognized a discrepancy of over 200 per cent. is certain to result.

I have so far considered merely the hazards inherent in estimates of reproductive costs, which are at least matched by those governing the amount of accrued depreciation deducted in determining "sound values." Depreciation has been the awe-inspiring subject of much learned, academic discussion, and the mental process, which decides between 10 per cent. and 20 per cent. on an item of $11,347 in the every-day practice of the average appraiser would probably be a revelation to those who tend to view the resulting fractional dollars as the outcome of scientific research and reasoning. As a rule, age in years combined with certain habitual annual rates for various classes of property often form the predominant background for the decision, somewhat influenced by outward appearance and occasionally by operating records and specific tests. This should not be taken as an indictment of all appraisers, because on the whole the results obtained by an experienced man with common-sense prove as acceptable as figures in accordance with highly theoretical investigation of deferred maintenance, inadequacy, utilization and obsolescence. In some instances, notably in patterns, dies, drawings, etc., further in major cases of functional obsolescence, mere "looking" at objects can not possibly reveal the facts, of course. The point I wish to emphasize is that lessening in value due to age, physical deterioration or any other cause introduces into all appraisals an element of uncertainty which even under favorable conditions is hardly less than plus or minus 5 per cent.

Again, the breakdown into smaller units is an important factor in judging the potential benefits of the law of averages, especially if the work has been performed by more than one person. A flat rate of 25 per cent. accrued depreciation, applied to a building as a whole, instead of individual percentages for walls, framing, roof, plumbing, etc., is unsatisfactory, unless the total amount involved is small in comparison to the total appraised investment.

At a time when many bankrupt enterprises continue operations by the good graces of creditors or bondholders, the question of assigning going-concern value to the fixed assets of a business be-

comes of outstanding importance. Even the busiest mill in the course of time accumulates unused and useless machinery and buildings, for which often market and salvage value do not differ materially. The accountant is in a strategical position to judge the degree of activity from records accessible only to himself. Unless the appraiser has previously obtained such information directly from the management, it must be the duty of the accountant to call attention to questionable situations. This applies not only to the liquidity and immediate prospects of the concern for profitable operation but, as well, to abnormal conditions in specific departments or products, so that inactive portions of the property investment may be segregated accordingly.

What are the conclusions that may be drawn from this evidence of limited certainty in the results of appraisal procedure in its present status? If they are understood by the accountant he may at once question the wisdom of the designation of results of non-mathematical compilations in units which lead to an erroneous impression of accuracy. If the limitations were indicated, the relative position of adopted figures within a range would furnish a welcome criterion of conservatism. It is further obvious that for purposes of ascertaining the total value of assets in a business enterprise, it is utterly useless to go into much detail in minor property classifications, if land, intangibles or other large single items are included.

However, it should be kept in mind that generally appraisals serve more than one purpose. Property control in all its phases, determination of depreciation rates and reserves, allocation of departmental overhead and other accounting uses may require extensive detail. To be effective as a proof of potential losses, appraisals for insurance purposes must contain a great amount of detailed information. But I have yet to find an instance where final extension of unit costs into fractional dollars adds anything to the value of an appraisal. This widespread nuisance causes substantial and often unrealized clerical expense in compilations and detracts from legibility of crowded summaries. No radical departure from present practice would be necessary to indicate the estimated degree of accuracy by consistent rounding off of totals and subtotals. While we are utterly in the dark when presented with a statement showing a total value of $769,600.15, a figure of $750,000 would be a good deal more informative and satisfactory, without in any way reflecting on the ability of the

appraiser. The desirable and justified degree of accuracy and consequently the scope of time, effort and cost of an appraisal must be determined by its intended utilization, when the extent of the investigation arrangement and presentation is decided. Many are apt to overlook in their striving for accuracy that appraisals are extremely perishable goods, especially in these days of rapid economic changes.

The most important conclusion from all the foregoing is the apparent need not to accept appraisals at face value, without some study of their background of method and accuracy. The inventory items, however voluminous or lacking in detail, deserve the attention of the accountant as evidence of care and technical skill exercised in the investigation and compilation. The sources of possible uncertainties furnish an effective medium for checking the consistency of valuations. Where logic is not apparent, questions should be asked. Definite answers will be forthcoming if a competent appraiser has been selected.

Legal Notes

HAROLD DUDLEY GREELEY, *Editor*

SHERMAN ACT

In 1890 congress enacted the Sherman anti-trust law which made combinations or monopolies in restraint of trade criminal offenses. This applies only to interstate commerce because congress has no power to legislate concerning trade which is confined within the territorial limits of a single state. The courts have construed the Sherman act to cover only unreasonable restraint and the test of reasonableness seems to be this: The restraint is reasonable if it merely furnishes reasonable protection to the contracting parties and does not jeopardize any interest of the public. Public-utility corporations can not combine and divide the territory to be served and thus avoid competition. Monopolies in public necessaries such as coal are illegal.

For many years prior to our present crisis business men have complained of the practical uncertainty in the administration of this statute. They have hesitated to engage in an economically sound venture when they ran the risk of going to jail years later if some jury or court somewhere should decide that their combination had been unreasonable. Economists and other students of public affairs have frankly questioned the wisdom of encouraging competition which was certain to leave only the strongest surviving and to impose on them a wholly unnecessary cost. Men in charge of trade associations and cost-finding groups have proceeded with caution. But none of this opposition has been effective, probably because the pain of a new idea and the inertia of a comfortably well-off majority naturally nurtured a policy of laissez-faire.

Now that the crisis is here, with its obvious over-production or under-consumption and its unbelievably low commodity prices, some change is imminent. Whether the Sherman act will go the way of a well-known amendment to the constitution, whether administrative laxity in enforcement will be encouraged, whether some governmental agency will be empowered to approve plans in advance, no one can say. But the latest decision of the United States supreme court is distinctly liberal and, as far as industries dealing in natural resources are affected, perhaps no legislative change will be needed.

In *Appalachian Coals, Inc., et al.* v. *United States*, 77 U. S. (L. Ed.) 623, the supreme court, with one judge dissenting, found no illegal restraint of trade in the following situation: one hundred thirty-seven producers of coal in Virginia, West Virginia, Kentucky and Tennessee formed a joint selling agency which was named Appalachian Coals, Inc. These producers controlled 73 per cent. of the commercial production in their territory and one inevitable result will be the elimination of competition among themselves. But the court held that as they were seeking fairly to improve conditions in their industry and as it would be impossible for them to fix selling prices because of the supply of coal obtainable elsewhere, there was no such unreasonable restraint as would violate the Sherman act. The fact that correction of abuses may tend to stabilize a business or to produce fairer price levels does not mean that a coöperative effort to correct them necessarily constitutes an unlawful restraint of trade. The intel-

ligent conduct of business through the acquisition of full information about all relevant facts may legally be sought by coöperation. Putting an end to injurious practices and improving the competitive position of a group of producers may be entirely consonant with the public interest where the group must still meet effective competition in a fair market and where the group neither seeks nor is able to effect control of selling prices. But the court retained jurisdiction over the matter in order that it might act promptly if occasion arose in the future to prevent violation of the Sherman act.

OBLIGATIONS OF POLITICAL COMMITTEES

After election comes the task of collecting for campaign supplies and services furnished on credit. When an accountant is called upon to render technical service on behalf of this or that candidate or that or this movement, he should decide first whether or not he will do so gratuitously as a contribution to a cause in which he believes. If his decision is in the negative, he then should make certain that there can be no misunderstanding as to who is to pay for his work and he should retain an attorney to prepare the agreements necessary to protect the rights of everyone concerned. Two recent decisions in New York emphasize the importance of this. In *Empire City Job Printing Co.* v. *Harbord*, 89 *N. Y. Law Journal* 1729, the plaintiff furnished two shipments of muslin banners to a political committee. The court decided that the members of such a committee were not individually liable on contracts made in the name of the committee unless they expressly or by implication pledged their individual credit. A political committee by its very nature is transitory. "When the agency is disclosed and the contract relates to the matter of the agency and is within the authority conferred, the agent will not be personally bound, unless upon clear and explicit evidence of an intention to substitute or to superadd his personal liability for, or to, that of the principal." In *President, etc.* v. *Koenig*, 89 *N. Y. Law Journal* 1985, an action was brought upon a promissory note signed with the full name of a political committee by the name of its president, in an attempt to hold the president personally. It was decided that no member could be held personally unless the president who signed the note had the authority to pledge individual credits of members. The status of the members of the committee was that of members of an unincorporated association. In an association of that sort formed for pecuniary gain, the members may be held as partners, but in one organized for political, social or benevolent purposes it will not be presumed or implied that an officer contracting a debt for the association had authority to bind the members individually.

NEED FOR STANDARDIZATION

The need for standardization and organization was strikingly illustrated upon the recent death of an official court reporter in Ontario, Canada. This reporter wrote a unique system of shorthand which no one else was able to read. After reporting the testimony in several trials, he died before he had transcribed his shorthand notes and no one able to decipher them could be found. In two of these cases, one of the parties desired to appeal but it was impossible to obtain a transcript of the testimony for use on appeal. The court of appeal ordered a new trial in each case. The parties were not restricted to the evi-

dence given at the former trials but were permitted to begin anew. *Patton et al.* v. *Yukon Consolidated Gold Co., Ltd., et al.*, 1933 O. W. N. No. 8, p. 154; *Olanow* v. *The Goderich Mfg. Co., Ltd., et al.*, 1933 O. W. N. No. 10, p. 183.

Apart from the delay and the matter of the cost to the parties and to the government, this procedure resulted in giving each party to the litigation a complete examination of the other party before trial. This may or may not have been conducive to the attainment of justice. If an accountant on the staff of a firm wrote a unique system of long-hand which no one else could read and made his working papers in a way which no one else could understand and then died before he had prepareo his report, the consequences might well be fully as serious as those in the Canadian litigations.

AUTHORITY OF CORPORATION'S SECRETARY

In *Nathan* v. *Regent Laundry Service, Inc.*, 89 *N. Y. Law Journal* 1521, the court held that the secretary of a corporation was a general officer with apparent authority to do any act which the board of directors legally could authorize or ratify. Thus a contract of employment executed by him as secretary bound the corporation, despite the fact that the corporation's by-laws provided that the secretary was a ministerial officer whose duties were limited strictly to the performance of such work as was merely secretarial in character. Such a by-law has no force as a limitation of authority against an outside person when the secretary performs an act within the apparent scope of a secretary's authority.

ENGAGEMENT RINGS

Accountants who in their cool, calm and collected manner contemplate matrimony should be apprised of a latent right. The appellate division of the supreme court of New York has just decided that a woman may not retain an engagement ring when she declines without cause to keep her promise to wed the donor. *Beck* v. *Cohen*, 262 *N. Y.* S. 716. In this case the ring cost $350, but the report does not show whether it had been paid for or the jilted man was to have a reminder of his romance whenever an instalment fell due. The court in its learned search for legal truth went back only to the year 1576. Two of the five judges dissented. On a rising diamond market the fair one might be justified in reimbursing the wooer for his cash outlay and keeping the profit. If the engagement were a long one, interest on the investment should be claimed as an element of cost.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these solutions and answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official solutions and 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 18, 1932, 1:30 P. M. to 6:30 P. M.

The candidate must answer questions 1 and 2, and any two of the three following questions:

No. 4 (18 points):

(a) At December 31, 1930, the Rightform Manufacturing Company was carrying, as current assets, certain temporary investments (at cost), whose respective market values you find to be approximately as follows:

	Cost	Approximate market values
Common stocks:		
400 shares Southern Pacific	$45,320	$37,500
220 " National Biscuit	18,600	17,080
50 " Western Union	9,415	6,675
U. S. Liberty Loan, 4¼'s of 1933–1938	21,950	21,150
	$95,285	$82,405

State clearly three methods (in order of preference from the viewpoint of conservatism) of treating these investments in the annual accounts.

(b) The Satisfaction Tailoring Corporation has funds on deposit in several banks, two of which closed during the latter part of 1931 and, at the date of your examination, have not reopened.

What is the conservative way to state these frozen deposits on the corporation's balance-sheet at December 31, 1931?

(c) The Interstate Holding Company owns capital stock of three subsidiary companies—A, B and C—amounting to 95, 90 and 60 per cent. respectively, of the total outstanding stock of each. In preparing statements of the holding company, for the guidance of its directors in deciding upon the declaration or omission of dividends, what cognizance, if any, would you take of the following conditions?

(1) The book value of A company's stock is less than that at which it is carried by the holding company, due to heavy losses incurred in the current and preceding years as a result of inefficient management.

(2) The book value of B company's stock is substantially less than that at which it is carried by the holding company, as a direct result of the subsidiary's having declared and paid dividends during the current year in excess of profits.

(3) C company's stock, which is carried on the books of the holding company at an average cost in the open market of $84 per share, is quoted on the New York stock exchange at $10.50 at the balance-sheet date. Investigation shows that this shrinkage is directly attributable to two factors: (a) adverse conditions in the industry, and (b) general financial conditions and other causes entirely unrelated to the business.

State briefly what your treatment of the foregoing factors would be in preparing a balance-sheet for the holding company.

Solution:

(a) These securities should be shown as current assets, as they represent the temporary investment of funds, are listed, and may be readily converted into cash. In the accounts, they may be shown:

(1) at market price,

(2) at cost, less a reserve for the decline in market price,

(3) at cost, with a notation stating the market price.

The entries for (1) and (2) follow:

(1)

Surplus		$12,880	
Securities			$12,880
To write down the values of the securities to market price at December 31, 1930, as follows:			
Book value	$95,285		
Market price	82,405		
Excess	$12,880		

(2)

Surplus	12,880	
Reserve for decline in market price of securities		12,880
To set aside a reserve for the decline in market price of securities at December 31, 1930.		

It will be noted that the charge in both cases is against surplus account, as the decline in the value of the securities represents, in the case of a manufacturing company, an extraneous and not an operating loss.

No entry is necessary under (3). The securities would be shown in the balance-sheet somewhat as follows:

Marketable securities—at cost (Market price, $82,405)	$95,285

There is but slight justification for the third method.

(b) In such cases wherein a recovery was made subsequent to the balance-sheet date and before the preparation of the statement, the amount so recovered may be stated as a current asset. However, such circumstances are unusual. In such cases where a recovery may reasonably be expected, a reserve should be set aside. The amount of the reserve depends upon the particular circumstances, but should, preferably, be set at 100 per cent. The bank balances and the reserves should appear in the balance-sheet as "other assets." If it is

known that no recovery will be had, the balances should be written off immediately.

(c) Adjustments should be made on the balance-sheet of the parent company to take up in its investment and surplus accounts, the profits, losses and dividends of its subsidiaries as mentioned under (1), (2) and (3). The effect of the decline in the market value of its investment in Company C would be then sufficiently reflected in the accounts of the parent company.

After giving effect to these adjustments, a consolidated balance-sheet should be prepared, which should also show the separate balance-sheets of all of the companies (after eliminating the reciprocal accounts). From this statement, the directors can determine the financial condition of each of the companies, and of the consolidation as a whole.

No. 5 (18 points):

The revenue act of 1932 provides for a tax of 13¾ per cent. of the amount of the net income of every corporation. If a consolidated return is filed, the rate is 14½ per cent. These rates apply to the entire amount of net income, as corporations are no longer allowed a specific credit. A net loss of a corporation may be deducted in the succeeding taxable year. Income-tax returns for the year 1932 are due on or before March 15, 1933.

A parent company owns all the outstanding common stocks of 62 operating companies, with the exception of qualifying directors' shares. The books of the parent company and of the subsidiary companies are audited annually by public accountants, and reports are submitted for each company, as well as a consolidated balance-sheet and a consolidated income and profit-and-loss statement.

The parent company maintains a tax department, and the income-tax returns are prepared by this department, but the public accountants are retained to give advice with respect to federal tax matters.

(a) In December, 1932, you are asked for your opinion as to whether a consolidated return should be filed or whether separate returns should be filed for each company. In giving your opinion, state briefly the factors you would take into consideration, with such qualifications as you deem necessary.

(b) You are also requested to confer with the company's tax department and suggest, in a general manner, methods whereby the return, or returns, may be prepared with a minimum of expense and with a consistent treatment of taxable items of income and deductions of all companies.

Do not submit forms: give only an outline of the procedure to be followed in the preparation of the return or returns.

Solution:

(a) A consolidated return should be filed unless the additional ¾ per cent. of tax is likely to more than offset the advantage of applying the deductible losses of certain companies against the taxable income of others. The factors to be considered are:

1. If a consolidated return is filed, all of the 62 subsidiary companies must be included in the consolidation.
2. If a consolidated return is filed for the year 1932, "a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the affiliated group) has become a member of the group during such subsequent taxable year, or (2) one or more provisions of these regulations, which have previously been consented to, have been amended, or (3) the commissioner, prior to the time of making the return, upon

application made by the common parent corporation and for good cause shown, grants permission to change." Regulations 78, article 11.

3. If the operations of the companies with losses result in small losses, and the taxable incomes of the other companies are large, the reduction in taxable income of the group may not offset the increase in the rate of taxation.
4. The companies with net losses may be able to apply these losses against their own profits in the succeeding year; however, if certain companies appear to be incurring losses regularly, the group may avail itself of losses which could not otherwise be used.
5. Inter-company profits or losses may be eliminated by filing a consolidated return.

An examination of the reports and returns for past years should be studied for the purpose of ascertaining what income taxes would have been paid if the current law had been in effect during those years, if

(1) a consolidated return had been filed, or
(2) separate returns had been filed.

This study should aid in making a decision on the points numbered 3, 4, and 5, above.

While an opinion may be stated in December, 1932, after giving consideration to the above factors, final decision should be withheld until the statements for the year 1932 are completed, and the taxes under both methods are computed. If the filing of a consolidated return would result in a lower tax for the year 1932, the factors above should be weighed to determine whether a similar benefit is likely to result from consolidated returns in the future; if a change is likely—or certain—to occur in the consolidated group in the next year (thus renewing the choice of methods) the consolidated returns should certainly be filed.

(b) If separate returns are to be prepared, uniformity can be obtained by first picking out in each case, the items specifically shown on the face of the returns: i.e., officers' salaries, rent, depreciation, taxes, interest paid, etc., and preparing uniform schedules for all other items of income and expense.

If a consolidated return is to be prepared, the same result can be obtained by the use of columnar sets of working papers, one set with items similar to those on the face of the return, and the other sets for the various schedules.

Examination in Auditing

November 17, 1932, 9 A. M. to 12:30 P. M.

Answer all the following questions:

No. 1 (10 points):

Auditing a corporation in the state of X for the calendar year 1931, you find on its profit-and-loss statement "Taxes paid, $4,200." The ledger account shows the following items:

"Feb. 1	State real-estate tax—½ of 1930	$1,200	
May 1	" " " "—½ " 1931	1,200	
Nov. 1	" " " "—½ " 1931	1,800	
Dec. 31	Contra to profit & loss		$4,200"

Supporting tax bills show that the assessments cover periods for one year from July 1st, agreeing with the state's fiscal year, the taxes being due and payable in two instalments, November 1st and May 1st.

You also discover an unrecorded unpaid bill for a state franchise tax of $3,000, due and payable November 1, 1931, for one year in advance.

Give your analysis of the items, and state how they should be treated.

Answer:

From the statement of the problem it would appear that on July 1, 1930, a real estate tax was assessed for the year ended June 30, 1931, payable in two instalments, on November 1, 1930, and May 1, 1931. (This interpretation may not hold in all states.) Accordingly, the corporation should charge its tax account for the year 1931 with one-half of the assessed tax for 1930 (applicable to the period January 1, 1931, to June 30, 1931) and one-half of the assessed tax for 1931 (applicable to the period July 1, 1931, to December 31, 1931).

From the ledger account it would appear that the amount of the assessments made at July 1, 1930, and July 1, 1931, were $2,400 and $3,600 respectively. The charge for real estate taxes for the corporation's fiscal year would be therefore:

½ of $2,400	$1,200
½ of 3,600	1,800
Total	$3,000

The payment made on February 1, 1931, for $1,200 applies to the period, July 1, 1930, to December 31, 1930, and should be charged against the operations for 1930, by means of the following entry:

Surplus	$1,200	
Profit and loss (surplus) (taxes paid)		$1,200
To transfer charge for taxes for year 1930 paid during 1931.		

The unrecorded unpaid state franchise tax of $3,000 should be entered to charge the operations for the year 1931 with its portion, $500, and to defer the remainder, $2,500, applicable to the following year. The entry to record this tax follows:

Taxes paid (profit and loss, 1931)	$ 500	
Prepaid taxes	2,500	
Accrued franchise tax		$3,000
To record the state franchise tax due and payable November 1, 1931.		

An adjustment should be made on the books for the state franchise tax of the preceding year, which tax was presumably paid on November 1, 1930. Five-sixths of the amount of this tax should be charged against the operations for the year 1931 by means of a credit to surplus.

No. 2 (10 points):

A bank engages you to audit the accounts of the Smith Manufacturing Com pany, which is seeking a loan. You find that the company is not incorporated and that A. B. Smith is the sole owner of the business.

How far will you go in determining and setting out in your report the personal assets and liabilities of Mr. Smith? State your procedure.

Answer:

The personal assets and liabilities of A. B. Smith, the sole proprietor of the Smith Manufacturing Company, should be considered in conjunction with the audit of the assets and liabilities of the company. The personal liabilities of Mr. Smith may be of such nature that he may feel compelled to withdraw assets from the company to satisfy those creditors, even to the extent of seriously depleting the working capital of the business. On the other hand, his personal assets may be such that, considered with those of the company, the loan sought could be safely granted.

Mr. Smith should be requested to give the data relating to his personal assets and liabilities, which should be verified by the auditor. Particular attention should be directed to the following:

1. Securities on hand, in transit, held in safekeeping, or pledged, should be inspected or confirmed, and valued at market price.
2. Real estate owned, with mortgages or liens, should be verified, noting particularly the maturity dates and amounts payable on the mortgages, liens and taxes. Any unpaid past due taxes should be listed.
3. Cash in banks and bank loans should be reconciled and confirmed; the source and nature of the deposits shown on the bank statements should be carefully noted.
4. Accounts and securities with brokers should be confirmed.
5. A search of the public records should be made to learn of any mortgages and judgments.
6. Information relative to life insurance should also be obtained.
7. Any other points which may arise during the examination.

If the personal assets and liabilities are relatively important, a statement showing (1) the financial condition of the company, (2) that of Mr. Smith, personally, and (3) both combined should be included as a part of the report. In any case, the scope and the result of the examination of Mr. Smith's personal affairs should be commented upon in the text of the report.

No. 3 (10 points):

State the method of verifying the following accounts in the audit of a stock-brokerage firm.

(a) Customers' accounts (cash balance and securities).
(b) Failed to deliver.
(c) Failed to receive.

Answer:

(a) Customers' accounts (cash balance and securities).

1. Obtain the original and a duplicate statement of the customers' accounts which should show the balances at the beginning of the month, purchases, sales, remittances, dividends, and interest during the month, and the balances at the date of the audit—all expressed in terms of cash. The customers' security positions should also appear. The duplicate should be retained by the auditor for future reference.

2. Check the statements against the ledger accounts, and against a trial balance of the customers' ledger accounts. The total of the net balances

shown on the statements should be checked against the general ledger control account.

3. Send the statements to the customers (the actual mailing should be done by the auditors) requesting that confirmations thereof be sent direct to the auditor. These confirmations when received should be examined for reported differences which in turn should be satisfactorily accounted for.

4. Obtain transcripts of the customers' margin accounts whereon should be detailed the customers' money balances, as well as their security positions; i.e., securities long, short and safekeeping.

5. Obtain a transcript of the broker's security position by securities, which should show a total position in each security, individual customers' positions in each security, and the location of the securities.

6. Verify the existence of the securities by count and by confirmation with banks, brokers, transfer agents, etc.

7. Check customers' security positions as shown by the ledger account and margin account, and brokers' security position against each other and account for all differences.

8. Account for all securities as shown by the transcript of the broker's security position either by count or confirmations.

9. Check the adequacy of the collateral security in the case of customers' margin accounts, and provide for actual and possible losses thereon.

(b) Failed to deliver:

These accounts, which represent balances due from other brokers for securities not yet delivered to them, should be accounted for and verified by obtaining:

1. A list of such balances from the firm's records, and
2. Direct confirmations from the firms to whom the securities will be delivered when the amounts due from them are paid.

(c) Failed to receive:

These accounts, which represent balances due to other brokers for securities not yet received from them, should be accounted for and verified by obtaining:

1. A list of such balances from the firm's records, and
2. Direct confirmations from the firms from whom the securities will be received when the amounts due to them are paid.

No. 4 (10 points):

In 1925 your client, a corporation, issued 100,000 shares of cumulative preferred stock. In 1927 it repurchased 20,000 of these shares and held them as treasury stock until 1932 when it sold them at cost. Dividends for 1930 and 1931 on the preferred stock were suspended, but were declared in 1932 together with the dividend for that year.

You find that the dividends on the 20,000 shares of treasury stock for 1928 and 1929 were entered on the books as income to the corporation, as were also the suspended dividends when declared in 1932, the purchasers of record of these shares receiving only the dividend for 1932.

How will you deal with this matter? Give your reasons.

Answer:

Dividends should be declared and paid only upon that stock outstanding in the hands of the public, and not upon treasury stock. If dividends are paid upon treasury stock and recorded as income, the earnings will be over-stated.

In the case in point (assuming a dividend of $7 per share), the profits have been over-stated as follows:

1928	$140,000
1929	140,000
1932	420,000

Although these dividends were charged to surplus, they were also credited to that account as a part of the earnings for the years 1928, 1929, and 1932. Accordingly, no adjustment in the surplus account is necessary. However, the earnings statements should be corrected, by eliminating the dividends on the treasury stock entered as income.

The contract of sale of the treasury stock should be examined to learn whether the purchasers of the stock were entitled to the dividends for the year 1932 only, or whether they were to receive all of the unpaid accumulative dividends. In the latter case, the liability for the amount of the suspended dividends not paid should be entered upon the books.

No. 5 (10 points):

(a) Define "trade acceptance." (b) What is its distinguishing characteristic? (c) As compared with customary trade methods of book accounts what are its advantages and disadvantages (1) to the parties thereto, (2) to the auditor, and (3) to business in general?

Answer:

(a) A "trade acceptance" is a "bill of exchange, drawn by the seller on the purchaser, of goods sold, and accepted by such purchaser."

(b) The distinguishing characteristic of the trade acceptance is that it arose out of a purchase of goods. It often bears evidence of this fact upon its face.

(c) (1) To the seller, the trade acceptance is more desirable because it is a promise in writing to pay a stated amount at a definite date; it can more readily (and at a lesser cost) be discounted, and thus release working capital which would otherwise be tied up in open accounts; to the buyer, the use of trade acceptances may result in more favorable terms of purchase, such as price and dating. However, if he is unable to meet his obligation at maturity, his credit standing might be impaired, particularly so, if the acceptance (a negotiable instrument) is in the hands of third parties. Furthermore, the buyer may have difficulty in obtaining adjustments, and would have no claim of offset against the seller if the acceptances were held by third parties.

(c) (2) To the auditor, the use of trade acceptances facilitates his work. Acceptances receivable and acceptances payable can be verified more quickly and completely than open accounts receivable and payable.

(c) (3) To business in general, the use of trade acceptances is an aid to the extension of credit; not only by the seller to the buyer, but by the banks to the seller, and the Federal Reserve Banks to the commercial banks.

No. 6 (10 points):

The A. B. Corporation lends money to its customers, taking their notes secured by warehouse receipts for merchandise in storage. All these notes, together with the warehouse receipts, are pledged by the corporation to secure bank loans.

What steps should the auditor take to verify the notes receivable at the date of his balance-sheet?

Answer:

A list of the notes receivable at the date of the balance-sheet should be prepared, which should show:

Date
Makers' names
Date of maturity
Amount
Rate of interest
Interest
Security

When confirming the bank loans, the auditor should request a list of the pledged notes and the security thereon to be sent direct to him. This list should be checked against the schedule which he has prepared. If his schedule shows notes not confirmed by the bank, he should ascertain whether they have been dishonored or paid. If dishonored, they should be on hand and he should note what action has since been taken to secure payment. If paid, the amount received should be traced through the corporation's cash records to the bank statement.

Even though the bank has accepted the notes as collateral for the loans made to the company, the market value of the merchandise evidenced by the warehouse receipts should be ascertained to determine whether the notes are fully, or partially secured.

No. 7 (10 points):

You are invited to address a regional bankers' convention on the subject of internal check in handling loans and discounts. Give an outline of what you would suggest.

Answer:

1. Require that all requests for new and renewal loans and discounts be approved in writing by an officer of the bank. This approval should be recorded on the notes or attached thereto.

2. Require prenumbered triplicate forms to be prepared containing complete information regarding each new loan, renewal loan, payment on loans, other loan changes, and changes in collateral security. The three copies of the forms will be disposed of as follows:

(a) Retained by note teller for reference and to be used in a tickler file as a basis for notices to customers, etc.

(b) Sent to general ledger bookkeeper to summarize and to support daily entries to "loans and discounts."

(c) Sent to auditing department.

3. Require auditing department to build up and maintain daily controls of loans and discounts. These controls should be arranged according to interest

rates of loans. The controls mentioned will be constructed and kept current by a summary of the entries indicated by the triplicate copy of the forms mentioned under (2). These controls will enable the auditing department to check daily the general ledger figures of "loans and discounts" and interest earnings.

4. Require the auditing department to maintain a control record by securities of all collateral held, and also a detail "margin account" for each collateral loan on which will be computed daily, the value of the collateral.

5. Cause the auditing department to make physical audits of loans and collateral at least four times a year. These audits to be made at unannounced times. In connection with each audit, the auditing department should reconcile its records of loans and collateral with the actual notes and collateral held by the note department.

6. Request confirmations from customers of loan balances and collateral in connection with each audit referred to in (5).

No. 8 (10 points):

In conducting an audit of a wholesale company, you note the following accounts on the general ledger:

Cash discounts lost (debit balance)	$1,432.73
Cash discounts not taken (credit balance).........	5,733.40

What, in your opinion, is the meaning of these accounts, and how will you dispose of them in preparing the income statement of the business?

Submit pro-forma journal entries illustrating a purchase and a sale under the procedure obviously followed by the company.

Answer:

The apparent meaning of the accounts mentioned is:

1. Cash discounts lost (debit balance) indicates that the company takes up as income at the time of purchase, all possible purchase discounts. Such discounts as are not taken are charged to this account.

2. Cash discounts not taken (credit balance) indicates that the company provides for all possible sales discounts at time of sale. Such discounts as are not allowed are credited to this account.

Cash discounts lost:

When a purchase is recorded in the voucher register or purchase record, the following debits and credits are made:

Purchases..................................	$1,000.00	
Discounts earned..........................		$ 20.00
Accounts payable..........................		980.00

When the invoice is paid, the following entry is made in the cash disbursements record:

(1) If the discount is earned:

Accounts payable...........................	$980.00	
Cash.....................................		$ 980.00

(2) If the discount is lost:

Accounts payable...........................	$980.00	
Cash discounts lost........................	20.00	
Cash.....................................		1,000.00

At the end of the accounting period, an examination of the unpaid vouchers should be made to ascertain the amount of the discounts lost on the past due vouchers, and the amount of the discounts available on the vouchers not yet due for payment. With this information the following entry should be made to correctly state the liability on the vouchers payable.

Cash discounts lost	$ xxx.xx	
Discounts earned	x,xxx.xx	
Accounts payable		$x,xxx.xx

The amount of the cash discounts actually earned during the period is the difference between the balances in the discounts earned account and the cash discounts lost account.

After the books have been closed for the period, the amount of the discounts available in the preceding entry should be reversed as follows:

Accounts payable	$x,xxx.xx	
Discounts earned		$x,xxx.xx

Cash discounts not taken:

When a sale is recorded in the sales journal, the following debits and credits are made:

Accounts receivable	$490.00	
Discounts on sales	10.00	
Sales		$500.00

When the remittance is received, the following entry is made in the cash receipts record:

(1) If the discount is taken:

Cash	$490.00	
Accounts receivable		$490.00

(2) If the discount is not taken:

Cash	$500.00	
Cash discounts not taken		$ 10.00
Accounts receivable		490.00

At the end of the accounting period an examination of the unpaid sales invoices (or ledger accounts) should be made to ascertain the amount of the discounts lost on those past due, and the amount of the discounts which may be taken on those not yet due for payment. The impracticability of securing this information is a decided disadvantage. However, these data are necessary, if the accounts receivable, and the discounts actually allowed during a given period, are to be correctly stated. The entry follows:

Accounts receivable	$xx,xxx.xx	
Discounts on sales		$xx,xxx.xx
Cash discounts not taken		x,xxx.xx

The amount of the cash discounts actually allowed during the period is the difference between the balances in the sales discount account and the cash discounts not taken account.

After the books have been closed for the period, the amount of the discounts on sales in the preceding entry should be reversed as follows:

Discounts on sales	$xx,xxx.xx	
Accounts receivable		$xx,xxx.xx

In the profit-and-loss statement the accounts may be shown as follows:

(1)

Financial income:		
Discounts earned (available)		$xx,xxx.xx
Cash discounts not taken		x,xxx.xx
Financial expense:		
Discounts on sales (available)		xx,xxx.xx
Cash discounts lost		x,xxx.xx

(2)

Financial income:		
Discounts earned (available)	$xx,xxx.xx	
Less—cash discounts lost	x,xxx.xx	
		$xx,xxx.xx
Financial expense:		
Discounts on sales (available)	$xx,xxx.xx	
Less—cash discounts not taken	x,xxx.xx	
		xx,xxx.xx

(3)

Show the net amount of the discounts actually earned, and actually allowed.

No. 9 (10 points):

State three methods of treating cash discounts on sales in the income statement and discuss the reasons for each.

Answer:

Cash discounts on sales may be treated in the income statement as:

(1) A reduction of sales.
(2) A selling expense.
(3) A financial expense.

(1) In certain industries, the cash discount rate may run as high as 8 per cent. or ten per cent. Because of the high rate, the discount is considered to be a trade discount, even though it can be deducted only upon the prompt payment of the invoice. Accordingly, in many cases, the discount is deducted from sales in the income statement.

(2) In other cases, the discount is considered as an inducement to the prospective purchaser to buy, and the amount allowed may be treated as a selling expense. Particularly is this so, where the operations of the credit department and of the selling department are closely affiliated. In such circumstances, the discount is considered not only as an inducement to buy, but also to pay promptly, with a resulting decrease in collection and bad debt expense.

(3) As cash discounts are offered, in many cases, for the purpose of securing capital for current operations without resorting to borrowing, the amount so allowed may be considered as closely akin to interest, and hence, a financial expense.

No. 10 (10 points):

In making an audit of a recently organized utility corporation, you find an entry on the books, supported by resolution of the board of directors, as follows:

"Franchises, Dr.	$50,000	
To surplus.		$50,000
To set up expenditures by incorporators prior to date of incorporation in connection with securing franchises."		

State what you would do and your reasons therefor.

Answer:

The franchise, the contract with the incorporators, and the minutes of the meetings of the board of directors should be examined first, to ascertain:

(1) The life, terms, etc., of the franchise, and the ownership.
(2) The amount actually expended by the corporation for the purchase of the franchise.
(3) The manner of payment.

From the explanation in the journal entry, it would appear that the corporation paid nothing to the incorporators. If the corporation acquired the franchise by a donation of the incorporators, the credit should have been made to "donated surplus."

If there is an agreement to pay the incorporators, the credit should have been made to a liability account. If the corporation reimbursed the incorporators with capital stock, the credit should have been made to the capital stock account. If with cash, the account charged with the payment should be credited, franchise account should be debited with the amount paid, and the entry given in the problem should be reversed.

Provision should be made for amortization of the franchise.

Institute Examination in Law

By Spencer Gordon

The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1932, have been prepared at the request of The Journal of Accountancy. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor,* The Journal of Accountancy.

Examination in Commercial Law

November 18, 1932, 9 a. m. to 12:30 p. m.

An answer which does not state reasons will be considered incomplete. Whenever practicable, give answer first and then state reasons.

Group I

Answer all questions in this group.

No. 1 (10 points):

Wolff was the selling agent for Knox Mills, Inc., and since 1924 had owned 100 shares of its common stock. Claghorn was president of the corporation. Wolff and Claghorn executed a contract under seal whereby Claghorn agreed to purchase Wolff's stock at par value at any time upon Wolff's request. Wolff gave Claghorn the right to purchase it if Wolff's contract with the corporation should terminate or at any time within 30 days after Wolff's death. The stock certificate was endorsed as follows: "This certificate is subject as to transfer to a certain agreement made between Jacques Wolff and Edwin B. Claghorn, dated November 15, 1926." This contract was made binding upon and to enure to the benefit of the executors, administrators and assigns of each party "provided that no assignment of this agreement shall be made by said Wolff without the written consent of said Claghorn." On November 3, 1930, Wolff duly requested Claghorn to purchase this stock and tendered it to him. Claghorn refused to purchase it on the ground that the contract was void for lack of mutuality and of consideration. Is this contract valid?

Answer:

The contract is valid. The mutual promises of the parties obligate Claghorn to buy the stock at Wolff's request, and obligate Wolff to sell in event of the termination of his employment or death. These promises are mutual options and form the consideration for each other. The contract is under seal, and in a few states consideration is unnecessary for a sealed instrument.

No. 2 (10 points):

Dupont drew a cheque on the X bank for $1.22 payable to the order of Alice Nugent. This cheque was fraudulently raised to $3,881.22 and the name of the payee changed to Alfred Nugent. Thereafter, this cheque was endorsed by Alfred Nugent and deposited by him in the B bank. The B bank endorsed it, guaranteeing all prior endorsements, and collected $3,881.22 from the X bank. Prior to the discovery of the fraud, Alfred Nugent closed his account with the B bank and disappeared. Upon whom does the loss fall and why?

Answer:

The loss falls on the B bank. Under the uniform negotiable instruments act, every person negotiating an instrument by qualified endorsement warrants that the instrument is genuine and in all respects what it purports to be, and that he has title to it. The X bank can recover the amount paid the B bank upon these warranties.

No. 3 (10 points):

A boy, twelve years old, whose mother had died and whose father had abandoned him, was being supported by a man who had known both of the boy's parents for several years but who was not related in any way to the boy. One year after this support began, the man procured insurance on the boy's life payable to the man as beneficiary. Two years thereafter the boy died. At all times, from the date of the application for the policy until the boy's death, the insurance company's general agent and its local agent or solicitor knew all of the facts and circumstances of the case. Is the policy valid?

Answer:

The policy can be enforced. Continued support of a foster child may reasonably justify an expectation by the foster father that the former will render him care and assistance in time of his need. Where there is such a relation between the parties, an insurable interest exists. It can not be conclusively determined from the facts of the instant case whether a sufficient interest has been shown, but although the insurance company can not waive the requirement that the insurer have an insurable interest, it can be estopped from questioning the sufficiency of that interest, and the acceptance of the premiums coupled with the knowledge of the facts will be held to have worked such estoppel in the present case.

No. 4 (10 points):

Mark Talbot was insolvent. In order to obtain a loan of $500,000 from Clark Gibbons, Talbot was compelled by Gibbons to purchase from him, for $378,000, a residence property known to be worth $250,000, and certain corporate stock of no market value for $80,000. Talbot signed a note payable to the order of Gibbons carrying interest at the legal rate of 6%.

(a) At maturity, will the note be enforceable by the payee?
(b) At maturity, will the note be enforceable by a holder in due course?

Answer:

Forcing a borrower to buy property at an exorbitant price as a condition to obtaining a loan at legal interest rates constitutes usury. The penalty for usury varies greatly under the statutes of the several states. Some laws have been construed to render a note providing for an usurious rate of interest void between the parties as to both principal and interest. Under other laws only the stipulation for the usurious interest is deemed to be forfeited, the note being enforceable as to the principal sum thereof. And still other statutes are held to affect only the interest in excess of the legal rate. Under statutes expressly declaring usurious contracts void, it is uniformly held that usury is a defense which may be set up against a bona fide holder, even of negotiable paper. No validity can be given to it by sale or exchange because that which the statute has declared void can not be made valid by passing through the channels of trade. If, however, the statute does not expressly declare the note void, a holder in due course will be protected in most jurisdictions.

No. 5 (10 points):

Theodore Crawford, in November, 1925, subscribed for 100 shares of the preferred stock of the M Corporation and paid $2,000 to the corporation on account. Crawford was induced to make and did make this subscription wholly because the corporation's treasurer had formally represented to him that the corporation had a surplus at July 1, 1925, and had legally paid a dividend in the month of July, 1925. Crawford sued for the rescission of his contract and the recovery of the $2,000, and the following facts were proved: On January 1, 1925, the corporation's books showed a deficit of $11,484.29. In the following May, a journal entry was made debiting deferred engineering and development expense and crediting surplus with $22,167.95 for "expenses charged off in 1924, deferred to future operations." This amount was 80% of the 1924 expenditures for engineering. At the same time the corporation paid $10,000 for 400 shares of its own common stock, which it proceeded to carry at an asset value of $10,000, although the book value immediately prior to this purchase was $6.27. The corporation declared and paid a dividend of $1,591.55 in July, 1925.

(a) On the facts as stated, should Crawford succeed in his action?
(b) If the facts as stated should be amplified, indicate the lines along which further inquiry should be made.

Answer:

(a) Crawford should succeed in his action to rescind the contract on the facts stated.

(b) The facts should, however, be amplified to show what has been the net income of the corporation from January 1, 1925, to July 1, 1925, to show the market value of the stock of the corporation when purchased and on July 1, 1925, and to show the character of the 1924 expenditures for engineering.

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if any are submitted only the first five answers will be considered.

No. 6 (10 points):

A debtor of the X bank, in liquidation, offered to compromise his indebtedness by the payment of $2,074.10. The state superintendent of banks agreed to consider this offer on condition that the debtor deposit the money in escrow and submit to an audit, and on condition, also, that acceptance of this offer be approved by the court having jurisdiction of the liquidation. The deposit was made and the audit completed but the debtor died prior to acceptance of the offer by the superintendent. The debtor's executor immediately demanded the return of the escrow deposit. Is he entitled to it?

Answer:

Assuming the state superintendent of banks had authority to represent the bank, the debtor's executor can not recover this deposit. The deposit was made as a pledge on the implied condition that the offer would not be withdrawn while the specified steps for its acceptance were being undertaken, and in the absence of evidence that a reasonable time for these steps had elapsed, the condition has not been met and the depositor or his executor is not entitled to the return of the deposit.

No. 7 (10 points):

Charles Little on his own behalf contracted to sell 1,500,000 gallons of molasses of the usual run from a specified sugar refinery, deliveries to begin three months after the date of the contract of sale. At no time did Little have

a contract with the refinery. Shortly after deliveries began, the refinery curtailed its output, for economic reasons, although there was no failure of the sugar crop and no fire or other accident or strike at the refinery. The refinery refused to sell to Little a sufficient quantity to enable him to deliver all of the 1,500,000 gallons. Has Little any valid defence in an action brought against him by the vendee for failure to deliver?

Answer:

Little has no defense to an action for non-delivery. In the absence of a clause conditioning delivery upon refinery output, the courts will not read such a stipulation into the contract.

No. 8 (10 points):

Belknap, for an adequate consideration, gave the following written instrument to Pinney on August 5, 1932:

New York, N. Y.

Thirty (30) days after date I promise to pay to the order of Albert Pinney One Thousand Seven Hundred Fifty Dollars ($1,715.) at Liberty Trust Company. Value received. Interest at 6%.

Robert Belknap
James Silliman
Agents of New York Turbine Company.

Against whom, when, and for what amount will Pinney be entitled to enforce this instrument?

Answer:

The note is due thirty days after issuance. The amount is that written in the instrument, $1750, with interest at 6 per cent. from date of issuance. Belknap and Silliman have indicated following their signatures that they sign on behalf of a named principal, and under the uniform negotiable instruments act they are not personally liable if they were duly authorized by such principal; the principal alone being liable. At common law, the agents alone would generally be held jointly and severally liable under this form of signature.

No. 9 (10 points):

(a) What circumstances can cause the dissolution of a partnership?
(b) Does dissolution necessarily result in the actual termination of the business formerly conducted by the partnership?
(c) What authority has a partner after dissolution?

Answer:

(a) The uniform partnership act specifies seventeen situations which may cause dissolution of a partnership. In general, these include expiration of the partnership agreement, a new agreement to terminate, change in the membership or bankruptcy of a member. Breach of the partnership obligations and/or inability to carry on business at a profit gives cause for termination at the instance of one of the partners.

(b) After dissolution, a partnership continues only for the purpose of winding up its affairs, but the business formerly conducted by the partnership may, of course, be continued under other management.

(c) A partner after dissolution can act for the partnership generally only to wind up its affairs.

No. 10 (10 points):

In September, 1928, Stone was 20 years and 6 months of age. He opened a margin account with stock-broker X and did a certain amount of trading. One

month later he transferred to X a similar account which he had with broker Y and caused to be delivered to X 400 shares of the then market value of $17,450. X paid Stone's debit balance of $13,907.91 to broker Y, thus leaving Stone an equity of $3,542.09 in these 400 shares. Two months later Stone closed his account with X, receiving from X $70.99 in full payment of his credit balance. Six weeks thereafter Stone rescinded his agreement with X, disaffirmed all of his transactions with X, and sued X to recover the amount of his equity in the 400 shares ($3,542.09) minus the $70.99 paid to him by X upon the closing of his account. Stone in June, 1928, had deposited $4,000 cash as margin with broker Y. At the time of Stone's disaffirmance of his agreement with X, the 400 shares transferred from Y had a market value of $14,227. How much, if any amount, can Stone recover from X?

Answer:

At the date of his disaffirmance, Stone was still in infancy. In most jurisdictions an infant is allowed to disaffirm a contract before reaching his majority, and while he may not sue without representation, such representative may be later appointed.

Upon disaffirmance of his contract, an infant can usually recover whatever he has paid upon returning any benefits received. The question is to determine the value of what he has paid the broker X. It has been held that where a commodity of fluctuating value such as stock is the medium of payment, the stock must be valued as of the time of disaffirmance, since it is on this date that the infant is entitled to the return of his payment subject to the broker's lien for the unpaid balance and upon the return of any payment theretofore made to the infant. It follows that with regard to the stock transferred from the broker Y, Stone can recover from X $14,227, less the broker's lien of $13,907.91 and less the $70.99 previously paid to him. It may be added that if this sum, which here amounts to $248.10, were greater than the original deposit with Y, Stone would probably be limited to his original deposit.

No. 11 (10 points):

A corporation's certificate of incorporation or charter provided in Article A that holders of preferred stock should be entitled out of surplus or net profits to cumulative dividends at 7%. Article E stated that in any liquidation or dissolution the preferred stockholders "shall be entitled to be paid in full the par value thereof and all unpaid dividends accrued thereon before any amount shall be paid or any assets distributed to the holders of the common shares." Article F read: "The preferred stock shall be subject to redemption at $110 per share plus all unpaid, accrued, or accumulated dividends thereon." The corporation was dissolved and after the payment of all creditors the funds available for distribution did not amount to the total par value of the outstanding preferred and common stock. At the time of dissolution no declared dividends remained unpaid and the preferred stockholders had received annually the full amount of their 7% dividends. How should the available funds be distributed between preferred and common stockholders?

Answer:

The rights of the respective stockholders are to be determined according to Article E of the certificate of incorporation. The funds are distributable first to the payment in full of the par value of the preferred stock. The remaining funds will be divided and paid to the common stockholders according to their respective shares.

No. 12 (10 points):

(a) What are the principal changes in the income-tax provisions of the revenue act of 1932 as compared with the revenue act of 1928?

(b) Explain, and illustrate by a simple example, how the gift tax will be computed (knowledge of the rates prescribed in section 502 is not required).

Answer:

(a) Principal changes in the income tax provisions of the revenue act of 1932 are: increase in normal tax rates and surtax rates, reduction of specific exemption, and abolition of earned income credit for individuals. Increase in rates and abolition of specific credit for corporations. Losses on sales of securities not allowed as deductions unless held two years. Net losses may be carried forward for only one year. Corporation acquiring property in a reorganization must use transferor's basis if 50 per cent. control remains in transferor. Time for filing petition for review of board of tax appeals decisions reduced from six months to three months.

(b) Transfers to any person during year to the extent of $5,000 are exempt from gift tax. Gifts above this amount are taxable after total amount of $50,000 has been reached. For example, a man makes the following gifts:

To A—$5,000.
To B—$10,000.
To C—$100,000.

He is allowed $5,000 exemption on each gift, leaving the gifts taxable as follows:

To A—nothing.
To B—$5,000.
To C—$95,000.

He is allowed a further exemption of $50,000, so that the net taxable value of the gifts is only $50,000. The $5,000 exemptions apply to each year, but the $50,000 exemption is for the taxpayer's lifetime, and is to be applied against the net gifts for each successive year until the $50,000 is exhausted. In computing the gift tax for any year after 1933, a tax is first computed on the aggregate taxable gifts for all the preceding years. This is deducted from a tax computed on the aggregate taxable gifts up to and including gifts in the taxable year. The difference is the tax for the taxable year.

Book Reviews

THE NEW BANKRUPTCY ACT, ANNOTATED, *Prentice-Hall Inc.*, New York.

With praiseworthy promptness the Prentice-Hall Company has already issued, in loose-leaf binder, the text of the bankruptcy act of March 3, 1933, with introduction, notes, references to previously existing laws and extracts from senate speeches that clarify the intention of those who wrote the law.

For the clarification of the law as it will be interpreted there will be issued additional sheets for this binder as soon as cases are tried and decisions rendered.

It is generally known, of course, that the new law tends to compel minorities of creditors to accept compositions, either extensions of time, changes of interest rate or part forgiveness of debt if the arrangements are approved by a sufficient number of creditors and also approved by the court or referee.

The section providing for reorganization of railways that are in trouble is, perhaps, the most important to investors. It is provided that when railways wish to make an arrangement with creditors under this act a trustee shall be appointed from a panel named by the interstate commerce commission. That gives some hope that these trustees will not be selected from the class of vultures that have so often picked the bones of unfortunate enterprises, encouraging even the idea that men may be selected for their suitability alone.

With this exception the law does not do much toward reform of the system by which the whole of the assets of enterprises in receivership is so often dissipated without benefit to creditors or to the debtor.

To a large extent the spirit of the law is similar to that of the law of England; the subordination of a minority of creditors to a sufficient majority is somewhat socialistic, but minorities so often have made objection with the hope that they will be bought off on better terms than others that their case will get little sympathy. Railways, farmers, certain corporations guaranteeing mortgages—but not general corporations—and individuals are most benefited by this law.

The act is entitled "An act to establish a uniform system of bankruptcy in the United States." That was superfluous; what was needed was an act to establish a uniform system of bankruptcy procedure—we have the bankrupts.

There is also included in the law a provision that the attorney general shall prepare and submit an annual report showing the amount of debt and of recovery covered by bankruptcy proceedings during the years; it would startle American business men if there were given with this report statistics showing the percentage recovered in Great Britain.

After all, this was to be a review of the book, not of the law; it is a matter for congratulation that such a convenient and well judged summary of the law has been so quickly put within our reach.

F. W. THORNTON.

FEDERAL INCOME TAXATION—1933 CUMULATIVE SUPPLEMENT, by JOSEPH J. KLEIN. *John Wiley and Sons, Inc.*, New York. 1135 pages.

Though perhaps a little late for use in preparing income-tax returns for the calendar year 1932, Dr. Klein's *1933 Cumulative Supplement* will be welcomed

by public accountants who have relied upon his excellent work of 1929 with its annual supplements. By delaying publication the author was enabled to include pertinent points of the new regulations No. 77 which, much to the exasperation of many taxpayers, were not available till February 18. It follows that we have the last word in government procedure in addition to the latest court and tax-unit decisions on debatable questions.

The author has made this supplement cumulative, which will permit the user to discard the supplements for 1930 and 1931, lessening by that much the drudgery of hunting up developments and changes since the publication of the original basic text of 1929. The arrangement of topics follows that of the original text with clear references to changes in the latter demanded by later decisions and rulings. With these two books before him the reader can readily find his way through the tax maze.

People who have relied upon Mr. Klein's clear expositions in the past four years will be sorry to read his announcement that this will be the last supplement he will undertake. While, as he says, active practitioners have at their disposal the modern tax services which keep their subscribers posted as to legislation, court decisions and treasury rulings affecting tax matters, nevertheless an interpreter who can translate legal verbiage into plain, understandable English as Mr. Klein does will be sadly missed. However, we are permitted to hope that later he may give a new and revised edition of his original book.

The format, binding and print, pleasing to the eye and convenient for consulting, are the same as for the original basic book, which is sufficient assurance to subscribers that the *Supplement* is a worthy companion of the original volume.

W. H. LAWTON

THE ETHICAL PROBLEMS OF MODERN ACCOUNTANCY, Lectures delivered in 1932 on the William A. Vawter Foundation on Business Ethics, Northwestern University School of Commerce. *The Ronald Press Company*, New York. 152 pages.

A collection of lectures by George O. May, J. M. B. Hoxsey, Arthur Andersen, Eugene M. Stevens, and J. Hugh Jackson, with an introduction by Vanderveer Custis, is the fourth group of a series of discussions purporting at least to deal with ethical problems. Some of the lecturers appear to have gone rather far afield or to have considered that accounting technique, being perhaps the outstanding problem of the art, is its principal ethical problem. Thus we have discussions of accounting treatment of depreciation, reacquired securities, foreign exchange and stock dividends, as well as of distinctions between capital and earned surplus; we are reassured as to the increased importance of the accountant in the business world and demand for his services, and instructed as to the method of conducting fact-finding investigations and business surveys for the purpose of aiding management to control operations through the medium of accounts; and we are reminded of the great increase in the breadth of the distribution of corporate securities and that financial statements of publicly owned organizations are of great importance.

Let him who is interested in the ethical problems of accountancy, however, not despair. There are pages in the book which, if they can not be had without

the absorption of copious quantities of technical instruction perhaps intended for university students, still are not over-priced. Professional ethics receives practical treatment at the hands of some of the lecturers and perhaps the encouraging and uplifting tone is the clearer because it is not too completely sustained. While it may be contrary to reviewers' ethics to quote, the point is best illustrated by citing a paragraph:

"Professional ethics is a type of self-discipline; it is enlightened selfishness imposed for the good of the profession as a whole. It is *not* altruism; it generally does *not* involve self-sacrifice; it merely means that in some instances the individual is expected to yield his own immediate personal advantage, but that even in doing this he will profit in the long run because of better conditions surrounding his profession. To state the matter differently, it means that the individual 'foregoes some immediate advantage for the sake of greater advantages farther on.' "

There is in the book a goodly amount of criticism of accountants, which is the more valuable because it is stated in the first person—the profession recognizing its present shortcomings in order to find the way for its future development—but there are also enough illustrations of the attainment of the greater advantages farther on by the foregoing of some immediate advantage to indicate that this type of vision is not wanting and that the future may be relied on to show satisfying ethical development. One lays down the book with a sufficient sense of gratification at instances of high ideals maintained, and the feeling that the day may in fact come when all accountants will be so imbued with the dignity of their profession as to be willing to measure their gain only partly in the currency of the realm and partly in the satisfaction which comes from work well done.

It is well that the literature of accountancy should tend to include discussions of its ethics, and the work under consideration includes worth-while contributions to this field.

F. B. Andrews

Accounting Questions

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

CASH SURRENDER VALUE OF LIFE-INSURANCE POLICIES

Question: I would like to know the prevailing practice with reference to loans of corporations from life-insurance companies on policies carried on the lives of officers. Should the full cash surrender value be shown as an asset and the loan against the policy shown as a liability, on the theory that a liability should never be deducted from an asset? Or should the loan be deducted from the cash value and the excess, if any, be extended as an asset?

I find that some clients want the cash surrender value put in current assets because it is recognized as such by the federal reserve bank, and it also improves their current position. In fact, in one case, this asset of cash value of life-insurance determined whether or not the paper of the concern was subject to re-discount. What is the prevailing practice in placing this item on the balance-sheet?

Answer No. 1: Certain details in the form of presentation in financial statements are reflections of the views of credit grantors. Some years ago it was more or less general practice to include the cash surrender value of life-insurance policies among current assets. This practice can, we believe, still be justified, though in recent years some bankers have indicated that in their opinion the cash surrender value of such life-insurance policies should not be included in current assets, but should be stated in the balance-sheet below the current asset section. We understand that the reason these bankers give for their opinion is that usually the cash surrender value will not be received in cash within a year from the balance-sheet date.

If you will refer to the January, 1932, number of THE JOURNAL OF ACCOUNTANCY, you will find an article by Anson Herrick, entitled "What should be included in current assets." On page 59 Mr. Herrick submits a balance-sheet prepared in what he terms "the usual procedure." In this balance-sheet the cash surrender value of life-insurance is included in current assets. On page 60 Mr. Herrick gives a balance-sheet prepared in accordance with his suggested procedure, and in this balance-sheet you will find the cash surrender value of life-insurance included under investments.

Occasionally a balance-sheet will be found in which it may not be desirable to include cash surrender value of life-insurance in current assets for the reason that the proceeds when received must be used for some purpose other than payment of liabilities or general corporate purposes. For example, the corporation may have entered into an agreement to purchase the stock of an officer whose life is insured, or perhaps the stockholders may have entered into an agreement by which the proceeds of a policy must be withdrawn from the corporation to carry out a similar purchase agreement between the estate of a deceased stockholder and the surviving stockholders. Under such conditions the cash surrender value of the life-insurance policy probably should be shown below current assets.

If there is a loan on a life-insurance policy, we consider it permissible either to show the cash surrender value as a current asset and any loan against it as a current liability or to show the cash surrender value below the current asset section with the loan as a deduction. Usually the source of the loan does not determine whether or not it should be included in current liabilities. However, since a loan against the cash surrender value of a life-insurance policy need not be repaid until realization of the cash surrender value or the face amount of the policy, there seems to be no good reason for requiring the loan to be included in current liabilities if the cash surrender value of the policy is not included in current assets. On the other hand, if there is a commitment to use the proceeds from the life-insurance policy for some purpose other than payment of current liabilities or general corporate purposes, any loan against the cash surrender value of the policy may be a current liability even though the cash surrender value is not included in current assets. In these circumstances, upon the death of the insured, if the company is to carry out fully its obligations under the contract, it would be obliged immediately to obtain (by borrowing or other means) an amount equal to the loan against the policy, since an amount equal to the proceeds of the policy must be disbursed under the corporation's commitment.

Answer No. 2: The best practice, we believe, is to show the net value of insurance policies immediately following current assets. Such values, though not current in the sense that they are being converted into cash in the normal course of business, still constitute a quick asset almost as liquid as cash in most cases. It is our practice to show the full cash surrender value with deduction for any loans thereon. We do not think it necessary to show the loan among the liabilities for the reason that as a practical matter it never becomes a charge against any of the assets other than the surrender value, and if the loan were included among the liabilities the ratio of assets to liabilities would be deceiving.

ACCOUNTING TREATMENT OF REVALUED ASSETS

Question: In pre-depression periods the tendency was to have an appraisal made of plant, machinery and equipment, to write up the book value thereof to the appraised valuation and to adjust the depreciation accounts in accordance with the appraisal. The net adjustment usually resulted in a credit to capital surplus account. It was the general custom to maintain the original low depreciation charge to profit-and-loss and to charge the excess of depreciation taken on the new valuation to the new capital surplus account which had been created by the adjustment giving effect to the appraisal.

The post-depression trend is to have the same assets appraised, which in almost every instance is a revision downward, with its necessary adjustments in capital surplus, and possibly the earned surplus accounts, and/or the readjustment of capital stock accounts. The reasons given, apparently, are that it will bring values down to present replacement cost; that it will reduce the amount of future depreciation charges; increase earnings of the company, and enable the company, when the depression period is over, to return to its dividend paying basis sooner than would be the case if the valuation remained on a pre-depression basis.

Assume that, on the basis of an appraisal, the plant accounts were written up in 1928 and a capital surplus was created. At that time the accountant wrote off depreciation on the appraised value but charged to operations only an amount equivalent to the depreciation on original cost and charged the difference to capital surplus. In 1932 the plant accounts were written down, again based upon an appraisal, and the capital surplus and part of the earned surplus were eliminated.

1. Should the accountant be consistent with the pre-depression period basis and insist upon charging to profit-and-loss account depreciation on the original cost of the assets for earnings-statement purposes?

2. If so, how should the excess depreciation credit be handled?

3. If the accountant is not to be consistent, please give reasons.

4. If the adjustment writing down the plant values required a reduction of capital stock, and if, in a subsequent year, partly due to decreased depreciation charges, the company operated profitably and resumed the payment of dividends, would not this result in a payment of dividends out of former capital?

Answer: The procedure cited in question 1 involves writing off through depreciation a book value which is already 100 per cent. written off. That can scarcely be regarded as consistent. The year 1928 and current re-valuations are not comparable for depreciation purposes. The one creates an artificial, the other cancels a real, depreciation obligation.

Whatever the accounting opinion on question 4 the legal view necessarily prevails. For that, too long to repeat here, we would refer the inquirer to Montgomery's *Financial Handbook*, particularly page 1590.

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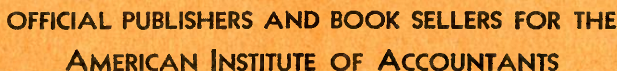

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