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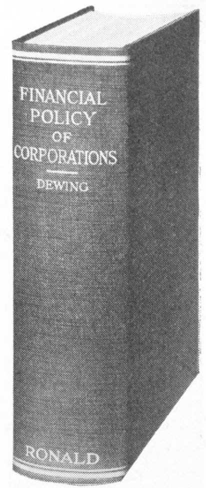

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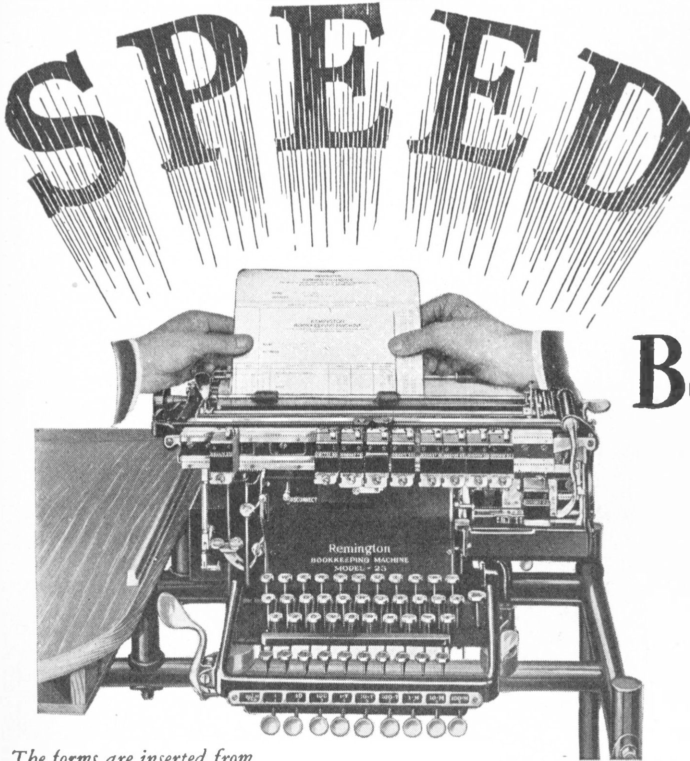

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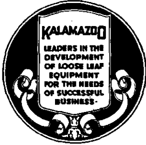

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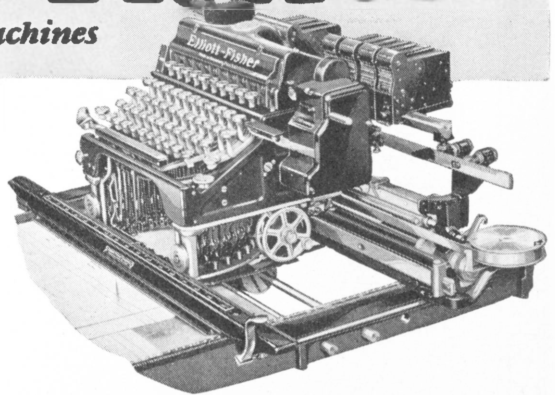

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Vol. 43 MAY, 1927 No. 5

Accounting for a Staple-cotton Plantation

BY ROY C. BROWN

The accountant's first assignment to an extensive staple-cotton operation will be almost an adventure in topsy-turvy land. He will become acquainted with accounts receivable which are expenses; with relations with so-called tenants who are in reality closely supervised employees; with actual conditions of depreciation necessitating the employment of percentages which may, at first, look fantastic, and with inventories of such shifting values that the use of them will manifestly not correctly reflect the income, or be expressive of the facts in the case.

Plantation accounting should preferably be confined closely to the history of the main product. Every activity of the plantation is subordinated to the raising of cotton. Statistics as to the value of feed crops compared with the cost of production will avail little, because the accountant can hardly bring into the record the value to the land of crop rotation and the nitrate-fixing properties of the legumes which are commonly planted with the corn crop. Cotton is the "money crop", the basis for credit, the maintenance for the day and the hope for the future. The value of any attempt to departmentalize the accounting or to elaborate on the cost of other farm products which are produced and consumed as an incident to cotton cultivation will be largely neutralized because of the tendency of such digressions to distract attention from the main and all-important issue—cotton.

Before considering the accounting, a brief discussion of the nature of the crop and its cultivation may be of interest. Cotton is the fibrous covering of the seeds of the species of Gossypium,

a genus belonging to the mallow family. What is known as staple cotton is probably a variety of the West Indian "G. Barbadense," and is akin to sea-island cotton, but shorter stapled. Varying according to latitudes, the production can be roughly summed up by periods as follows:

Breaking land and burying vegetation, December and January.
Bedding up and fertilizing, February and March.
Planting, April.
Cropping out to stand and throwing soil up to roots, May.
Ploughing out grass and throwing dirt up to roots, June.
Picking, beginning in August.

The plant usually appears above ground in from one to two weeks after the seed has been sown. In about forty days after the appearance of the plant, the "square" or bud develops. In about another thirty days the flower opens, showing a dull white or yellow color on the first day and a pinkish hue on the second, and dropping off on the third day. After the petals fall there remains the boll, enveloped in the calyx; this develops until it becomes almost the shape and size of an egg, and finally bursts, about sixty days after the appearance of the bloom. When the boll bursts it exposes several cells divided by membranous walls, each cell containing seeds attached by filaments to the membrane of the boll. These filaments disappear, leaving the seed loose in the cavity and covered with the fiber known as cotton. When first picked from the boll it is known as seed cotton, which is separated by ginning into cotton seed and lint cotton.

The average yield per acre is from 1,000 to 1,200 lbs. of seed cotton, giving by weight about one third lint and two thirds seed. The moisture content in the lint runs about eight per cent. and most of this disappears between the time of picking and marketing.

The cultivation is almost universally done by contract labor, negro families who are described as "tenants," and known as "half-hands" or "quarter-hands." In the case of half-hands, the owner furnishes living quarters, fire-wood, work animals and tools, without charge, and charges the tenant with one half of the cost of the seed, fertilizers and poison for dusting to protect the

plant against insect pests. Under this arrangement the farm takes one half of the lint cotton, the seed and one half of the lint cotton going to the tenant. Quarter-hands furnish their own tools and work animals, and the farm takes only one fourth of the lint.

In either case the owner furnishes the tenant with his necessities, advances him cash and produce against his crop and, beginning March 1st and continuing until August 1st, pays him a stipulated amount monthly, or bi-monthly, of $1.50 to $2.00 a month per acre of cotton he is cultivating. This payment is known as a "limit." An average of seven acres of cotton land per adult member is assigned to a family, and considerable judgment is needed to prevent families from taking on more land than can be worked efficiently, in order to increase the "limit."

A separate account is kept with each tenant, and all advances, including the limit, are charged against his account. When the cotton is picked, ginned, baled and graded, the owner settles with the tenant for the seed and for his share of the cotton at the current market price. A proportion of the plantation overhead, which usually masquerades under the name of "interest," is charged to the account; the cotton and seed and any miscellaneous credits are passed to the account, and the tenant receives the difference in cash. If the production is not sufficient to pay out the account the owner is in nine cases out of ten forced to close out the balance into the cost of the crop. Thus, for the tenant, it is a case of "heads we win, tails you lose." These accounts with tenants are, properly speaking, not accounts receivable at all, but merely a segregation of the cost of producing the crop. In the preparation of returns of income all the debits should be considered as production expense, and none of the accounts charged off should be considered as a bad-debt deduction. Where debit balances are small and where the family has good workers who normally make a profit, the balances are commonly carried forward if the tenant elects to remain on the place and cultivate another crop, the effect being to lessen slightly the cost of producing the subsequent crop.

When we bear in mind the irresponsible character of the labor, the risks of damage to grade and weight by storm, insect pests, early droughts, later and excessive moisture, and also the frequent and violent fluctuations of the market, the conclusion is inevitable that the cultivation of cotton is a continuous gamble.

The best estimate that the writer has been able to make of the cost per acre to produce "wages" cotton, as distinguished from cultivation by the tenant system, is given below as an average production cost for use in testing figures.

Man hours, all operations up to picking, 70 @ 20¢	$14.00
Feed raised on plantation, cost	.75
Feed bought	2.00
Seed, cotton, pedigreed seed, 50 lbs. @ 3½¢	1.75
Poison and dusting	.80
Fertilizer	2.00
Depreciation, work animals	1.50
Depreciation and repairs, buildings	2.00
Depreciation and repairs, farm machinery, gin, etc.	1.50
Small tools, hardware, harness and supplies	1.00
Interest on bank advances, average	1.60
Picking, 1,000 lbs. seed cotton	15.00
Overseer, hostler and blacksmith	2.80
House expense, not deductible for income tax	3.00
Cleaning and opening ditches	.50
Taxes, including school, road and drainage	3.00
Ginning, baling and hauling	3.00
Cost per acre (1,000 lbs. seed cotton)	$56.20

The assumption is fair that the seed from one acre of cotton, sold to the oil mills on laboratory test, will bring an average of one cent a pound for 640 lbs., which deducted from the above table leaves a net cost of the lint cotton in the bale (360 lbs. less 8% moisture, net 335 lbs.) of practically fifteen cents a pound, or fourteen cents, if we exclude the "house" or owner's account. In years when the crop is practically a failure, all the costs remain about the same, excepting that of picking, and the owner suffers heavy losses.

The avenues to credit open to the planter are various, and the accountant should investigate very thoroughly the possibility of the existence of liabilities to banks, factors, investment bankers, oil mills, the federal land bank, the staple discount corporation, and jobbers and machinery houses. It may be necessary to examine the land book and the mortgage record in the chancery office of the county courthouse to determine not only the existence of liabilities but also whether or not part extinguishments have been made matters of record, and in some instances, where properties have been disposed of, to determine the original cost.

The chances are that the sum total of the records the owner will be able to produce will be entirely inadequate and not even approximately in accord with good accounting practice. Usually the accountant can depend on finding available records somewhat as follows:

Statements from cotton factors or coöperative marketing associations,
Tax receipts and invoices for some or all of the supplies bought,
Canceled cheques and bank statements,
Account book with tenants, and possibly a payroll book,
Gin ticket stubs, if a gin is operated.

The general accounts must be built up from this foundation. Even if an attempt has been made to keep general accounts these will usually be limited to cash, plantation, cotton, expense, house, and loss and gain. Depreciation will very rarely be reflected by the books, and the owner will be inclined to consider the term as a convenient device allowed him to lower the taxable net income on his return. Indeed, until the income-tax law of 1917 came into existence, many planters made no attempt to keep a system of books, and literally thousands of deficiency assessments have been made, and will continue to be made, because examining officers can not verify the income and deductions from the records presented to them.

Hence the problem of the accountant who is first called in is quite as much a matter of education and conciliation as of producing a fair balance-sheet, a reasonably accurate profit-and-loss account, and, particularly if the engagement has been the outgrowth of a deficiency assessment, income returns that will stand up under inspection.

Procedure will vary with conditions. Usually the first step will be to set up the property accounts intelligibly. Lists of the structures should be prepared, with the cost, or estimated cost, or March 1st, 1913, value; equipment and machinery reasonably segregated and properly valued, and the value of the acreage segregated from the value of the structures and any standing timber on the property.

Next, there should be an examination of the gin ticket stubs and other gin records, if a gin is operated, to determine the

number of bales ginned from new and previous crops, the weight of seed and of cotton, prices allowed tenants and amounts charged for bagging and ties and tolls.

Then the tenant ledger on which the accounts with the so-called tenants are kept should be analyzed on wide columnar paper, to find the bales of cotton and pounds of seed credited to each account and any miscellaneous credits, as well as the charges against each account, segregated as merchandise, feed, bills paid, corn-land rent, gear and implements, rent of gear and implements and of live stock, hogs and cattle, the so-called interest charge and other debits. If work animals are found charged to tenant accounts, it will be well to suggest to the owner that such a charge technically completes a credit sale, and that possible trouble and expense of repossessing may be avoided by suspending such charges until settlement time, and bringing them on to the ledger page if the tenant can turn over enough cotton and seed to clear the account, including the cost of the animals.

After the digest of these records is completed, the canceled cheques and bank statements for the period, with statements from oil mills, factors and coöperative selling associations, purchase invoices and payrolls should be carefully examined, distributed and summarized.

Where a commissary is operated there will probably be a separate small set of books, with inventories, which can be tied up with the other records. As the commissary man is customarily interested in the profits, these books should receive special attention. It is usually well to make a complete list of jobbers, retailers, and supply and machinery houses with which the owner has been dealing, and to write to each a request for information as to any debit or credit balances carried against the planter or plantation as of the closing date of the period under review.

The books of account suitable for a plantation cultivating a thousand or more acres of cotton and operating a store and a gin are as follows: general ledger, tenant ledger, cashbook, journal, payroll book, gin book, gin ticket books, commissary ledger, commissary combined cashbook and journal. Subsidiary records: cards for mules, horses and machinery, commissary inventory sheets, settlement sheets for tenants, and numbered tags for the gin.

The following chart of accounts will be found good practice, subject to such changes as conditions may suggest:

Assets

1. Cash account
2. Bank account
3. Accounts receivable, tenants
4. Accounts receivable, others
5. Notes receivable
6. Inventory, commissary
7. Stocks and bonds
11. Cleared land
12. Cut-over land
13. Wood land
14. Standing timber
21. Owner's residence
22. Overseers' houses
23. Tenant houses
24. Tenant barns and outbuildings, including seed houses
25. Main barns
26. Blacksmith shop
27. Gin buildings, seed house and platform
28. Commissary building
29. Bell tower and other outbuildings
31. Artesian well and piping
32. Lighting plant
33. Farm machinery
34. Trucks, tractors and automobiles
35. Tractor-drawn ploughs, trailers, etc.
36. Wagons and harness, plows, cultivators, etc.
37. Power plant, gin
38. Gin machinery
39. Hand implements and miscellaneous
41. Saddle horses
42. Work horses
43. Work mules

Liabilities

51. Accounts payable
52. Notes payable
53. Mortgages payable
54. Reserve for depreciation
55. Accrued taxes payable, state and county
56. Income taxes payable
60. Proprietor's account

NOTE.—Hogs and cattle can permissibly be treated as expenses when purchased and as revenue when sold. On a cotton plantation neither their number nor value will usually warrant setting up an asset account for them.

Income

71. Sales, cotton
72. Sales, cotton seed
73. Sales, other farm products
74. Sales, feed
75. Sales, commissary
76. Sales, timber
77. Gin tolls
78. Sales, bagging and ties
79. Interest and discount
80. Dividends and bond interest
81. Rent
82. Miscellaneous income

Expenses

91. Purchases, cotton
92. Purchases, cotton seed
93. Standing timber severed
94. Purchases, commissary
95. Purchases, bagging and ties
96. Purchases, miscellaneous, for resale
97. Planting seed (cotton)
98. Feed, purchases
99. Salaries, overseers
100. Salaries, bookkeeper, commissary clerk, etc.
101. Salary, gin operator
102. Gin payroll
102a. Gin supplies
102b. Gin fuel
103. Farm payroll
104. Planting seed, other than cotton
105. Fertilizer
106. Poison
107. Small hardware and harness
108. Repairs to owner's residence (not deductible for income tax)
109. Repairs, other farm buildings
110. Repairs, farm machinery
111. Repairs, gin buildings and machinery
112. Repairs, wagons and implements
113. Repairs, trucks, autos and tractors
114. Gas, oil and supplies, trucks, autos and tractors
115. Miscellaneous supplies
116. House expense (not deductible for income tax)
117. Depreciation
118. Taxes, state and county
119. Taxes, income
120. Interest on notes payable
121. Interest on mortgages
122. Rent, additional acreage
123. Miscellaneous expenses
130. Profit and loss

Many plantation owners follow a practice of maintaining a plantation account to which they credit the farm's share of the cotton at the immediate market price, and charge a corresponding

amount to cotton purchases. In the foregoing charts such a device has been entirely eliminated, for the reason that the market on cotton has a habit of doing a very "devil's dance" at the most unexpected intervals, which usually makes it necessary to eliminate these entries in order to make a true accounting. Likewise no provision has been made for a cotton inventory, because such cotton as is carried is usually stored in a bonded warehouse, and credits against this cotton are extended on surrender, as collateral, of negotiable warehouse receipts on which weights and grades are stated.

A footnote at the bottom of the balance-sheet showing the bales of unpledged cotton on hand and tons of seed is more satisfactory than an attempt to fix a value on a product that may be off or on several hundred points in a week. Incidentally, farmers are not required to use cotton inventories and seed inventories in preparing returns of income for tax purposes.

In this article it has been attempted to outline a strictly utilitarian system, devoid of frills and devoted to accounting for the main product, but with operations outlined in sufficient detail to permit the preparation of a statement by which an experienced and understanding reader may estimate the attention given to upkeep and management, and the productive possibilities of the plantation. There is probably no known industry which combines as many operations or provides as many temptations to delightful little experiments in cost accounting as does a large farming enterprise. But the opinion of one who has been "through the mill" is given, for what it may be worth, that an accounting for a staple-cotton plantation should be reduced to the essentials and confined to the utmost simplicity consistent with good practice.

[The writer wishes to acknowledge his indebtedness to Professor George B. Walker, of the Stoneville Pedigreed Seed Company, Stoneville, Mississippi, for valuable information related to the subject of this article.]

Amortization of Discounts on Serial Bonds

By F. C. Belser

It has been a common practice to apportion the discount on serial bonds over their life on the basis of the par value of bonds outstanding at the end of each year. This has been done on the assumption that a distribution made on this simple arithmetical basis is substantially accurate and equivalent to amortizing the discount on a scientific basis.

In some circumstances the arithmetical method yields substantially accurate results. For instance, in the following case, taking $200,000 of bonds payable in four instalments of $50,000 each, interest at 6% to yield 7%, the bonds would have a present value of $195,623, or a discount to be amortized of $4,377, and the result would be:

	Amount of bonds outstanding	Arithmetical basis	Scientific basis
1st year	$200,000	$1,751	$1,694
2nd "	150,000	1,313	1,312
3rd "	100,000	875	904
4th "	50,000	438	467
		$4,377	$4,377

In some cases, however, instead of showing a constantly declining amount of amortization from year to year, the scientific result is actually the other way about and gives a constantly increasing amortization. For instance, in the following case, taking again $200,000 of 6% bonds to yield 7%, but payable at $5,000 per annum for twenty years, and the last $100,000 also payable at the end of twenty years, the present value would be $182,688, or a discount of $17,312. In this case the amortization on the two bases would be as follows:

	Amount of bonds outstanding	Arithmetical basis	Scientific basis
1st year	$200,000	$1,135	$788
2nd "	195,000	1,107	793
3rd "	190,000	1,079	799
– –	–	–	–
– –	–	–	–
– –	–	–	–

	Amount of bonds outstanding	Arithmetical basis	Scientific basis
– –	–	–	–
20th year...........................	105,000	596	981
		$17,312	$17,312

In the second case, the scientific result is directly the opposite of the arithmetical result. The reason is that in some circumstances the basis rate applied against the amortization of the first period is greater than the difference in rates applied against the redemption of bonds. For instance, in the first case cited, the second year's amortization is $382 less than the first year's amortization, and is made up as follows:

7% of $1,694	= $118	plus
1% (7% minus 6%) of $50,000 =	500	minus
Net effect on amortization	$382	minus

In the second case there is an increase in amortization of $5 which is accounted for as follows:

7% of $788	= $55	plus
1% of $5,000 =	50	minus
Net effect on amortization,	$5	plus

Although the arithmetical method is often the more conservative and causes the deferred charge to be written off more rapidly, the scientific method is entirely justifiable.

Another consideration which often affects a schedule of amortization of discount is that some bonds are retired before their due date. When this happens it follows that corresponding adjustment should be made of the unamortized discount. The adjustment required is the difference between the par value of the bonds retired and their true present value at the original yield rate. This adjustment is brought out in the following schedule of amortization of the discount on the first bond issue illustrated above:

	Principal	Yield @ 7%	Interest @ 6%	Amortization on scientific basis	Bonds retired
1st year	$195,623	$13,694	$12,000	$1,694	$50,000
2nd "	147,317	10,312	9,000	1,312	50,000
				362	20,000*
3rd "	78,991	5,529	4,800	729	50,000
4th "	29,720	2,080	1,800	280	30,000
				$4,377	

* $20,000 of bonds due in 4th year retired in 2nd year.

It follows that any amount paid on the retirement of a bond in excess of its net yield basis would require to be written off to profit and loss. Thus, in the foregoing case, if the $20,000 of bonds retired were bought at 101, the journal entry would be as follows:

Bonds outstanding	$20,000	
Profit-and-loss account	562	
Cash, purchase @ 101		$20,000
Deferred charges		362
Purchase of $20,000 of bonds @ 101	$20,200	
Present value @ 7% yield	19,638	
Excess over value	$562	

As has been shown above, the amortization of the discounts on serial bonds is in some circumstances a constantly declining amount and in other circumstances a gradually increasing amount. It follows that there might be circumstances in which there would be the same amount of amortization throughout the life of the bonds. This is in fact the case. Take the case of a 6% bond issue of $600,000, payable in instalments of $17,500 a year for twenty years with the remainder of $250,000 at the end of twenty years. On a 7% basis the present value of these bonds would be $550,000 and the discount of $50,000 would be amortized at the rate of $2,500 for every year during the entire period, as is shown by the following table:

	Principal	Yield @ 7%	Interest @ 6%	Amortization on scientific basis	Bonds retired
1st year	$550,000	$38,500	$36,000	$2,500	$17,500
2nd "	535,000	37,450	34,950	2,500	17,500
3rd "	520,000	36,400	33,900	2,500	17,500
– –	–	–	–	–	–
– –	–	–	–	–	–
– –	–	–	–	–	–
20th year	265,000	18,550	16,050	2,500	267,500
				$50,000	

From the foregoing it will be seen that the practice of amortizing bond discount on the arithmetical basis should be abandoned, and the scientific basis adopted in every case. With the application of Makeham's formula it is a very simple matter to

get at the true yield of serial bonds. The application of this formula is set out fully in an article by A. S. Little, on page 352 of volume XXI of THE JOURNAL OF ACCOUNTANCY (May, 1916). For convenience this formula is given below:

$$\text{Present investment value} = \left(\begin{array}{c}\text{Present value}\\ \text{of principal}\\ \text{of bonds}\end{array}\right) + \frac{\text{Coupon rate}}{\text{Yield rate}}\left(\begin{array}{c}\text{Compound discount}\\ \text{on the principal}\\ \text{of the bonds}\end{array}\right)$$

This formula applies whether the principal of the bonds is in one sum or payable serially. In the latter case, the present value of the annuity represented by the serial payments would be found for the first member of the equation.

In all calculations involving the determination of a yield or basis rate, the process followed must be one of trial and error. It is, therefore, often convenient to find the first trial rate by some simple arithmetical method. A close approximation to the true rate may be obtained by adjusting the coupon rate by an aliquot part of the discount over the life of the bonds, and comparing the adjusted rate with the average of the principal sum, that is, the average of the present value and the par value. Thus, in the case of a 5% bond with 20 years to run, purchased at 90, the adjusted income rate would be 5.5% and the average principal would be 95, giving a rate of 5.79%, which closely approximates the true yield rate of 5.86%. In the case of serial bonds, their average life may be used as a factor.

The arithmetical method results in a rate somewhat lower than the true rate in the case of bonds at a discount and slightly greater than the true rate in the case of bonds at a premium.

The Accountant's Certificate in Connection with the Accountant's Responsibility*

(Concluded)

By Sir William Plender

Legal proceedings brought against auditors of limited companies by way of misfeasance summons or otherwise have been comparatively few in number. In the majority of reported cases relating to misfeasance it has been sought to make the auditor liable, on the ground of breach of duty, to refund jointly with directors dividends alleged to have been wrongfully paid out of capital owing to failure on the part of the auditor to detect and report either the non-existence, misdescription or overvaluation of assets or the omission of liabilities, disclosure of which would have shown that profits were not available for distribution. Having regard to the fundamental basis of limited liability it would seem equitable that the auditor ought not to be called upon solely on the ground of payment of a dividend to implement assets in the hands of a liquidator except to the extent required to meet claims of creditors (and possibly to indemnify holders of after acquired shares), bearing in mind the fact that the then existing shareholders themselves received the dividend in question. Such a limitation of the auditor's liability does not, however, appear to be regarded by the court as a defense available to the auditor; when, however, the shareholders who received the dividends knew at the time that they were improperly paid, the auditor, apparently, has a right of recovery from them. The extent of the auditor's liability in the circumstances mentioned is not, however, necessarily limited by the amount disbursed in dividends. He may be held accountable for loss or damage suffered by the company resulting from the cumulative effect or repetition of initial wrongs or errors for which he was originally in no way responsible, but which he failed to bring to the notice of the shareholders.

Having regard to the decisions of the courts which I have attempted to summarize, the auditor can not, I think, complain

* A paper read before the International Accountants' Congress, Amsterdam, 1926.

that they place too heavy a burden upon him. The legal standard of duty expected is high, but not too exacting having regard to the professional status which practising accountants have attained. It is true to say that the reputation enjoyed by the professional accountant does not rest upon his adherence to legal principles, however important; it is mainly by reason of the accountant's regard for his much wider moral duty and responsibility that he enjoys the confidence of the business community and the public generally. The mere observance of legal requirements may develop into a formality and render easy the evasion of responsibility upon technical grounds. No such limitation of our responsibilities should be permitted to influence the conduct of our professional business.

Although the auditor is responsible primarily to the shareholders, yet in the light of modern company development a somewhat wider view should, I think, be taken by the auditor himself. He should remember that balance-sheets of public companies are, for practical purposes, public documents: they are studied by the stock exchange and the prospective investor when forming an opinion as to the value of the share and debenture capital; they are made available to traders as an indication of financial stability and they are used by the companies themselves when raising bank loans and making other financial arrangements. Bearing in mind the variety of purposes for which an audited balance-sheet may be used, the auditor should refrain from taking too narrow a view of his responsibilities, and his object should be not merely to shield himself from legal consequences, but to realize and accept as the basis of his duty the more important moral responsibilities which the position involves.

It is not the duty of the auditor to prepare the balance-sheet; that is the responsibility of the directors assisted by the officials of the company. The auditor is concerned to see that the shareholders are given a true and correct view of the state of the company's affairs and the sole medium of his communication with the shareholders is his report. He is not accountable to individual shareholders or groups or classes of shareholders, but to the shareholders as a body. Primarily, the shareholders look to the directors for information as to the financial position of the company, and rely upon the auditor to point out in what way the balance-sheet may fail to reflect a true and correct view of the state of the company's affairs. Hence qualifications in the audi-

tor's report are apt to be regarded with disfavor by directors and with suspicion by shareholders. In practice, therefore, the auditor may be able to exercise considerable influence—by advice or persuasion—over directors in regard to the form in which accounts are presented to the shareholders.

Every balance-sheet is a summation of facts and opinions. It should represent what, in the judgment of the directors, is a fair statement of the financial position of the company, having regard to the object for which it was formed and to the existing circumstances and future maintenance of its business. It should be drawn up in such a manner as to afford shareholders an adequate means of ascertaining by perusal and inquiry the value of their interests without disclosing information likely to cause loss or injury to the business. It is the province of the auditor to apply his trained mind to a critical examination of the balance-sheet with a view to seeing whether, in his opinion, it substantially fulfills these conditions. He is not required to certify to an exact state of affairs, but he must be satisfied in the light of the evidence available to him that the balance-sheet is properly drawn up in accordance with customary usage.

The auditor will naturally be largely guided in the opinions he forms by the proved ability and character of the directors and officials entrusted with the management and conduct of the company's affairs; more particularly must he rely upon them in connection with matters involving expert and specialized knowledge of the industry concerned which he himself can not reasonably be expected to possess. In the main, however, the financial problems of every business are much the same and differ only in degree, and in considering such questions the auditor is able to bring to bear a mind capable of impartial and expert judgment and discrimination.

The duties of the auditor, as laid down by statute, may conveniently be summarized in two words—verification and report. He has first to examine the books and obtain information and explanations; thereafter he has to submit a report setting forth the conclusions at which he has arrived as the result of his investigation and inquiries. The first stage of his duty concerns the ascertainment of facts; the second stage necessitates the expression of an opinion based upon the exercise of independent judgment.

Now, in regard to the former, it may be said, subject always to exceptional circumstances, that there are certain facts which an auditor is bound to verify independently, viz.:

(1) The existence of such of the physical assets as are capable of verification by inspection or trustworthy confirmation from sources other than the company's officials. Such assets would include cash in hand, investments bills receivable, freehold and leasehold property, security held against advances and the like.

(2) The amounts of balances owing by or to the company's bankers and other debts and liabilities of exceptional character, not arising from normal trading operations.

The auditor must, generally speaking, satisfy himself as to the existence of other assets, if any, and the extent of the liabilities by the evidence of the books and records verified as far as necessary or practicable, having regard to the volume of the business and its internal organization, and supplemented by information and explanations obtained from the company's officials. And in this connection it may be noted that the practical application of scientific accountancy to all classes of business has largely minimized the risks of fraud by means of defalcation and embezzlement.

Any inability on the part of the auditor so to verify the existence of assets or any doubts he may entertain as to the omission of liabilities and commitments should be clearly stated in his report. Instances are common of companies whose operations abroad render it impossible for the auditor himself to examine accounts kept locally, and in such cases reliance must to a considerable extent be placed upon returns either audited locally or certified by the officials in charge. The fact that the balance-sheet incorporates accounts not under the immediate purview of the auditor should be specifically referred to by the auditor in his report. I do not propose to enlarge upon these basic principles except to say that responsibility can not be evaded by self-imposed limitation of duty which the circumstances do not warrant even if the auditor reports the extent to which he has restricted his examination. His duties are statutory.

Having satisfied himself as to the correctness of the transactions recorded in the books and the existence of the assets, the auditor has to consider whether the balance-sheet submitted to him by

the directors is presented in such a form as will justify him in reporting thereon in the words of the statute without qualification or supplemental observations. The legislature has rightly considered the conduct of private enterprise to be the concern of business men, and has refrained from undue interference in matters of domestic policy affecting shareholders as a body. The form and contents of the annual balance-sheet and accounts presented to the shareholders by the directors are not prescribed by law except in certain cases (e.g. life-assurance companies, building societies, railways and other public-utility undertakings governed by special acts of parliament) where the nature of the business and privileges enjoyed are such that special financial information is necessary in the public interest. Apart from these exceptional instances, the question of the information to be disclosed by the balance-sheet and the form in which it is submitted to the shareholders are, except to the extent that the directors may be bound to comply with any directions duly given by the company in general meeting, matters within the sole discretion of the directors subject to any regulations contained in the articles of association. In the words of Lord Justice Lindley, "it has been very judiciously and properly left to the commercial world to settle how the accounts were to be kept." The directors alone are responsible for the administration of the company's affairs and are accountable to the shareholders for their acts.

Undoubtedly, there has been a growing tendency during the past few years to curtail—in some cases unreasonably—the information afforded to shareholders. The remedy is in the hands of the shareholders themselves. The auditor has no power to insist upon a fuller disclosure of details by directors, and yet, unless the balance-sheet be in his opinion actually misleading, he can not well report that it is not properly drawn up so as to exhibit a true and correct view of the state of the company's affairs. So to do would be to confuse his duties and responsibilities with those of the directors; the auditor should be careful to distinguish between what may appear to him to be desirable as opposed to what is essential, remembering that a mistaken view of his duties might be the cause of embarrassment and loss to the shareholders, whose interest he is appointed to protect. When, however, the auditor is not satisfied that the balance-sheet discloses a true and correct view of the state of the company's affairs, and considers that it is incorrect or misleading, he should

convey his views in clear and unambiguous terms to the shareholders.

The auditor should have a clear conception of the attitude he should take up in regard to the values placed upon the various assets. Whilst he is not a valuer in the ordinary sense of the word and can not be expected to place values upon fixed assets, such as land, buildings and plant—indeed, such assets are not, in the ordinary way, revalued for balance-sheet purposes—yet he can generally obtain sufficient information to enable him to form an opinion as to the adequacy of the provisions for the amortization of the book values of wasting assets. If he is not satisfied on this point it might be his duty, but only after reviewing the whole circumstances, to make a qualification in his report. In regard to many liquid assets, however, he should be able to form, and if necessary express, a view as to the values adopted in the balance-sheet. Otherwise the opinion he is required to give as to whether the balance-sheet exhibits a true and correct view of the state of the company's affairs will be of little or no value to the shareholders. Qualifications in auditors' reports largely arise in connection with values placed upon the assets by the directors, and in this connection it is of the utmost importance to appreciate the bearing which such valuations have upon the financial position of the company as disclosed and the profits shown as available for dividend.

In Great Britain, the auditor is confronted with a series of somewhat involved legal decisions given as a result of applications to the courts to determine to what extent it is necessary for the share capital of companies to be preserved intact as an essential condition to be fulfilled before a dividend can be paid. Each case necessarily has reference to the specific facts and circumstances before the court and in particular to the company's own domestic regulations so far as such regulations are not inconsistent with the statute; the decisions, therefore, can not be regarded as laying down any unalterable or fixed rules which should be slavishly followed. In the words of the lord chancellor (Lord Halsbury) in the case of *Dovey* v. *Cory:*

> "The mode and manner in which a business is carried on, and what is usual or the reverse, may have considerable influence in determining the question what may be treated as profits and what as capital. . . . It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution. I desire, as I have said, not to express any opinion, but as an illustration of what

difficulties may arise the example given by the learned counsel of one ship being lost out of a considerable number, and the question whether all dividends must be stopped until the value of that lost ship is made good out of the further earnings of the company or partnership, is one which one would have to deal with. On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero and possibly involve its ruin. On the other hand companies can not at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us, and I am the more averse to doing so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a court of law."

In the same case, Lord Macnaghten said:

"I do not think it desirable for any tribunal to do that which parliament has abstained from doing—that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances and speaking for myself, I rather doubt the wisdom of attempting to do more."

Nevertheless, observations made by judges in summing up evidence and facts before them in specific cases are useful and instructive and enable us to contrast what may be held to be legally sufficient with what is regarded as financially sound and commercially prudent. I have extracted from the judgments the following passages as illustrative of the way in which the courts approach these questions:

"But if the court sees that the directors and the company have acted fairly and reasonably . . . the court is very unwilling to interfere with the discretion exercised by directors who have the management of the company. . . . The act does not say what expenses are to be charged to capital and what to revenue. Such matters are left to the shareholders; they may or may not have a sinking fund or a deterioration fund, and the articles of association may or may not contain regulations on those matters; if they do, the regulations must be observed; if they do not, the shareholders can do as they like so long as they do not misapply their capital. . . . The companies acts do not require the capital to be made up if lost . . . I can not find anything in them which precludes payment of dividends so long as the assets are of less value than the original capital. . . . The act says nothing to make the loss of the capital a ground for winding-up. . . .

"The proposition that it is ultra vires to pay dividend out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest trading. If you treat it as an abstract proposition, that no dividend can be properly paid out of moneys arising from the sale of property bought by capital you find yourself landed in consequences which the common sense of mankind would shrink from accepting. On the other hand if the working expenses exceed the current gains, you can not divide your capital under the head of profits when there are no profits in any sense of the term. . . .

"It is said . . . that a company is not to be at liberty to pay a dividend unless they can show that their available property at the time of declaring the dividend is equivalent to their nominal or share capital. In my opinion, such a contention is untenable." (*Lee* v. *Neuchatel Asphalte Co., Ltd.*)

"The broad question . . . is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles . . . there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital of a company is intended for use in some trade or business, and is necessarily exposed to risk of loss . . . if the capital is lost the company is under no legal obligation either to make it good, or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the companies acts, there is no law which prohibits the division of such assets amongst the shareholders. . . . There is no law which prevents a company from sinking its capital in the purchases or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact. . . . It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. . . . Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word 'capital' means the money subscribed pursuant to the memorandum of association or what is represented by that money. . . . But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape . . . if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavored to explain . . . the word 'profits' is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends can not be paid out of capital than by saying that they can only be paid out of profits. . . . Perhaps the shortest way of expressing the distinction which I am endeavoring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law. . . . Capital lost must not appear in the accounts as still existing intact; the accounts must show the truth and not be misleading or fraudulent." (*Verner* v. *The General and Commercial Investment Trust, Ltd.*)

" . . . Where a company has made losses in past years and then makes a profit out of which it pays a dividend, the question is a different one. Such a dividend is not paid out of paid-up capital. If it were, the paid-up capital would be still further reduced by the payment. In fact, the assets representing the paid-up capital remain the same or of the same value as before the payment of the dividend. It may be that the balance to the credit of profit-and-loss account ought to be applied in making up lost capital, and it may be that the directors are liable for neglecting to apply it in this way. But such a payment does not involve a reduction of capital, it involves a failure to make good capital which has already been lost. . . . If payment of dividends out of the balance to the credit of profit and loss is open to attack, it is, I think, on the ground (omitting any question of

dishonesty) that the course adopted is one which is contrary to the practice which governs all competent business men in the keeping of their accounts. This is possibly another aspect of the distinction, on which stress has sometimes been laid, between the two propositions that dividends must not be paid out of capital and that dividends can only be paid out of profits. . . .

" . . . What is circulating capital and what is fixed capital is a question which in many cases may well embarrass the business man and the accountant, as well as the lawyer. According to some of the definitions the same asset may be fixed capital in one company and circulating capital in another. . . . I am not satisfied that the proposition that it is contrary to all principles of commercial accountancy to utilize an increase in the value of a fixed asset for the purpose of getting rid of a debit which represents loss of paid-up capital is not too wide. It may be a precept of prudence and yet be far removed from the sphere of the categorical imperative. Assuming that a company ought to keep the value of its assets up to the amount of the liabilities and paid-up capital or, in other words, to see that its paid-up capital is intact, why should it be absolutely precluded from stating the true value of its assets? . . . If it is necessary or proper that a company shall maintain its assets at the amount of its paid-up capital liabilities, there would not appear to be anything illegitimate in showing that the assets are equal to the paid-up capital and liabilities. Nor for this purpose can it matter that the increased value is due to the fixed assets. The paid-up capital is represented by both fixed and circulating capital, and it seems somewhat arbitrary that circulating capital may be shown at its true value while fixed capital must not. Take the case of a depreciation fund. The effect is that the value of the assets as shown in the account is diminished by the amount of the depreciation fund. If the assets in fact increase in value to the extent of the depreciation fund, there is no rule which prohibits a company from wiping out the depreciation fund from the liabilities side of the account . . . directors would no doubt not be justified in ascribing to a fixed asset a value which is the result of purely temporary fluctuations. It is one thing to treat an unrealized increase in value of a fixed asset as profit and to pay dividends out of it as profits; but it appears to me to be a different question whether in considering whether there is a deficiency in paid-up capital owing to past losses, which ought to be made good out of future profits, the real value of the assets can be ascertained with the object of discovering if, in fact, there is a deficiency in the paid-up capital. . . .

"The directors, no doubt, would have been better advised if they had obtained a revaluation from some expert valuer, although, if one may judge by the evidence on the subject which I have heard, the margin of difference between the views of valuers on the subject is very great. But there is no rule of law which requires directors to obtain outside assistance in such matters or prevents them from valuing the property themselves, provided, of course, that they act honestly in doing so." (*The Ammonia Soda Co., Ltd.* v. *Arthur Chamberlain and others.*)

"I proceed on a principle as old as the beginning of company law—the principle, namely, that in matters of the kind here in question—matters necessarily of estimate and opinion—a company is presumably the best judge of its own affairs . . . a manufacturer requires or resolves to discard certain machinery and to replace it with other machinery more effective or more economical. Here again, the sacrifice in the case of the old machinery is simply an item in the cost of the change. . . . And although it may be a prudent and proper thing to provide for the recurrence of such expenditure, and to set up a renewal fund, that is a question which the trader considers for himself, and one as to which even in the case of limited companies, courts of law are not accustomed to interfere." (*Cox* v. *Edinburgh and District Tramways Co., Ltd.*)

"It is necessary, however, to consider whether the depreciation in goodwill and leases is to be treated as loss of 'fixed' capital or of 'floating or circulating' capital. . . . Depreciation of goodwill seems to me to be loss

of 'fixed' capital. It closely resembles the loss which a railway company might be said to sustain if it were found that a line, which had been made, say, ten years ago, at a certain cost, could now be made for a very much smaller amount and, consequently, would not yield if it were sold the price expended in making it." (*Wilmer* v. *McNamara & Co., Ltd.*)

". . . the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequence of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word 'profits' is rarely observed in drawing up the accounts of firms or companies." (*The Spanish Prospecting Co., Ltd.*)

Although the courts confine themselves to the interpretation and administration of the law it will be seen that practical considerations are not unheeded. If legal requirements are complied with the judges are disinclined to interfere with or restrict the discretion of business men in a course of action, which, whilst exceeding legal requirements, may be sanctioned by custom and dictated by prudence. On the other hand, if directors prepare accounts solely on the basis of legal requirements, the court will not regard their action as blameable even if it be recognized that prudence should or might have dictated another policy.

Assets as a rule can not be specifically earmarked as representing the share capital, neither does the expenditure on fixed assets necessarily correspond to the share capital subscribed. The proposition that floating or circulating assets must be kept up or be shown at their true value is, generally speaking, not at variance with commercial practice. Instances arise which give great concern to an auditor—such as the value of securities owned or lodged as collateral against loans where the securities are not quoted or it is extremely difficult to ascertain their immediate or ultimate worth, where a loan is entirely unsecured and repayment is not made within the period of its currency as arranged with the borrower, where trade debts are overdue and bills receivable are repeatedly renewed. No exact rules for the treatment of such cases can be laid down. The auditor must reach his own conclusions, from the available facts, as to whether he is justified in giving an unqualified report if no adequate inner reserves exist to protect the institution in the event of the directors' and management's views as to values in the instances cited perhaps proving to be optimistic.

It is in regard to the treatment of fixed asset values that considerable divergence of opinion may arise between the legal aspect and the business conception of the balance-sheet. Neither

has nor should have regard to break-up values: the function of the balance-sheet is to show the position of an undertaking as a going concern and not to show the probable result of liquidation, a fact not always appreciated by those who are inclined to criticize published accounts. The value of fixed assets such as buildings, plant, machinery, etc., acquired for the purpose of producing profits should not be regarded for balance-sheet purposes as dependent upon their cost of replacement or upon earning capacity. The intrinsic value may, for various reasons, fluctuate widely from to time; the only stable and known factor so far as the company is concerned is their cost. Cost may therefore be said to be the correct initial basis of value; but the auditor must have regard to the maintenance of the fixed assets and provision for their ultimate renewal and in this connection temporary falls in value are not by themselves ground for adverse report. There is no obligation upon directors to have assets valued by independent experts. Indeed, unless a sale be contemplated, it is frequently a matter more of academic than practical interest to attempt to estimate any variation in value. Any depreciation so computed could hardly be regarded as lost capital or capital unrepresented by assets provided a systematic and adequate provision for depreciation had been set aside; the effect of such a provision should go far to rectify any probable shrinkage in value and should adjust to appreciably their correct relationship the value of the fixed assets with that part of the share capital sunk in the undertaking.

The expediency or otherwise of writing off goodwill out of profits and making provision against other capital expenditure not represented by tangible assets is a question of policy and as such does not concern the auditor; but the balance-sheet should show the facts in these respects. Practically the only fixed assets to which a market value can be attached consist of permanent investments as, for example, shares possessing stock-exchange quotations; but the size of the holdings and benefits derivable therefrom in addition to dividend income may have a material bearing upon their real worth apart from their purely investment value.

The extracts from judgments of the court to which I have already drawn attention show an appreciation by the judges of the difficult and delicate nature of our duties, and there is legal recognition of circumstances which may justify secrecy and the adoption of a course of action dictated by prudence. The latitude

allowed to directors is illustrated by the following definitions by judges of what a balance-sheet should convey:

> "A full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position or suggest anything which can not be supported as fairly correct in a business point of view." (*Re London & General Bank, Ltd.*)
>
> "If the balance-sheet be so worded as to show there is an undisclosed asset, whose existence makes the financial position better than that shown, such a balance-sheet will not in my judgment be necessarily inconsistent with the act of parliament. Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probable real value. The purpose of the balance-sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better." (*Newton* v. *Birmingham Small Arms Co., Ltd.*)

These judicial utterances are helpful as indicating that the legal perception of the balance-sheet is not wholly uninfluenced by practical considerations of business expediency. Not seldom is it the fact that there are undisclosed reserves whose existence is a necessity for the well-being and security of the institution. To publish those reserves might be not only inexpedient but damaging, and the dicta of the learned judge just quoted is a justification for reasonable reticence and business prudence honestly exercised. An auditor who issues a report whose terms are ill-judged and without a due sense of proportion by a confusion of his duties with those of the directors and management, against whose probity and business capacity there is no reflection of allegation, may do infinite and irreparable harm. And on the other hand by an easy compliance with the views of others and by subordinating his own judgment to that of men whose management of an institution has been indifferent and faulty, as disclosed by the books, he would injure those who look to him for protection. An auditor in such cases must not only exercise sound judgment, but display courage regardless of consequences if he believes himself to be in the right. If the auditor's judgment be attacked the onus rests upon him to show that the facts and circumstances of the particular case justified the report he has signed. And therein lies the responsibility; an opinion will not by itself afford protection to the auditor if the view he acts upon and expresses is subsequently held to have been formed carelessly or without sufficient inquiry.

I now pass on to a brief review of the responsibility attaching to the accountant in connection with certificates issued for inclusion in prospectuses or offers for sale inviting the public to sub-

scribe for or purchase shares and debentures in industrial undertakings.

The development of joint-stock enterprise in Great Britain, great and beneficial as has been its effect, was not unattended by some disadvantages, as it afforded scope for the activities of dishonest persons seeking to enrich themselves at the expense of the unwary. Much has since been done by the legislature to protect the investing public by making compulsory the disclosure of material information and by rendering directors and promoters personally liable in respect of incorrect or erroneous statements appearing in prospectuses offering share and debenture capital for subscription. And apart from such legislation, the stock exchanges in Great Britain have greatly assisted in safeguarding investors by withholding quotations, and thus rendering securities largely unnegotiable, in cases where prospectuses do not comply with their requirements.

There is no statutory obligation upon companies to publish in prospectuses a record of trading profits for a series of years, or a statement of their financial position at a recent date. It has, however, become the almost regular practice for such information, when available, particularly as regards profits, to be given in the form of an accountant's certificate for two reasons: (1) the certificate generally speaking relieves directors and promoters from responsibility in regard to the facts it conveys, and (2) the certificate serves as an assurance to the public that the figures are reliable.

The vast amount of capital subscribed each year for the development of industrial undertakings is both an indication and a justification of the value attributed to such certificates. The accountant who furnishes such a certificate whether or not he thereby incurs any legal liability is at any rate morally responsible, first to promoters and directors who, relying upon the results of the accountant's investigation as embodied in the proposed prospectus certificate, proceed with the formation and flotation of an existing business as a public company, and, secondly, to investors who apply for and take up shares and debentures in established or in newly formed companies, and may have been influenced in doing so by the indication of earning capacity as reflected by the certified profits of past years.

It is, I think, true to say that no class of accountant's certificate has greater publicity than the prospectus certificate or is wider in

its influence and appeal. The auditor is not responsible for the preparation of accounts or the form in which they are presented to shareholders: his report thereon follows the wording of the act subject to necessary qualifications. In the case, however, of prospectus certificates he is solely responsible for the manner in which they are framed: they are his entire creation, and his sense of responsibility should prevent him from signing a certificate whose terms, whilst technically correct and sufficient, may nevertheless be presented in such a manner as to render the true results obscure and lend themselves open to wrong construction and inferences. A certificate liable to criticism on such grounds is none the less reprehensible because the impression it conveys was unintentional on the part of the certifying accountant. It is his duty to exercise all necessary care and caution to prevent possible misunderstanding, and whilst endeavoring to comply with the reasonable wishes of his client the accountant should remember that his first concern—which is not inconsistent with his client's true interests—must be for the public. The responsibility for the form of the certificate must, therefore, rest entirely with the accountant, and he should reject any suggested modification of the form of certificate which in his judgment the circumstances do not warrant.

It is a truism to say that the accountant in such a certificate must confine himself to facts: it is not within his province to make or certify estimates, neither should he express an opinion as to the probabilities or possibilities of the future. But the facts stated should be adequate and sufficient. The period in respect of which it is desired to quote the profits is a factor of considerable importance. A short period of exceptional prosperity clearly due to abnormal circumstances in the specific business or trade would by itself be an unfair criterion to adopt; whilst, on the other hand, unfavorable results attributable to price cutting and trade strikes or other depressing influences might also by themselves not do justice to the merits of the security offered. The detailed explanation which the bearing of such unfavorable conditions has had on profits is more a matter for the directors to deal with in the prospectus than the accountants in their certificate. In such circumstances, the period selected should be sufficiently long to enable the financial effects of abnormal prosperity or depression to be viewed in their true perspective. The manner of arriving at the profits should be suitably described to indicate the adjustments considered necessary and made in the figures as shown by

the books and accounts in order to arrive at the desired result, namely, the balance of profit which remains (after providing for prior charges, if any) to meet appropriations to free reserves and interest or dividend upon the security offered. It is, of course, true that the results for a past series of years do not take into account the increased profits which the employment of additional capital is likely to yield. But the accountant should refrain from attempting to prophesy the annual benefit likely to be derived therefrom and should leave the directors responsible for the carrying on of the business to make their own estimate in this respect.

Many important questions of accounting arise in the adjustment, for the purpose of a prospectus certificate, of the profits shown by the books and the annual accounts. It is permissible to delete charges which can properly be regarded as capital outlays but which for reasons of prudence have been written off against profits, and reserves made by a company for contingencies which have not arisen may properly be eliminated. The re-allocation of expenditure charged in any one year over a series to which they properly apply is frequently necessary. On the other hand there may be expenditure of an exceptional and non-recurring nature which, whilst properly provided for out of profits, is not an annual charge, and the income itself may have been augmented by extraneous profits not arising from the normal trading activities of the company. The extent to which the accountant must qualify his certificate in all or any of these respects can only be determined by a review of individual circumstances. The trend of the profits is of great importance, and for this reason the figures for each year should be stated separately. Where the results reported upon include those of a broken period they should be stated separately: it may be misleading to compute the yearly profits by reference to those earned during a portion of a year.

The natural desire for brevity in certificates should not, of course, be allowed to curtail a statement of all necessary figures and explanations. Conciseness is very desirable, but it is sometimes found that both the interests of the company and the public will be served by figures giving additional information bearing on the amount of the profits, such as the gross turnover; dividends paid; the amount of share capital outstanding from time to time; the annual expenditure upon repairs and renewals, and the provisions for depreciation. One occasionally sees an accountant's certificate which does not state the profits of each year, but at-

tempts to convey what is the earning capacity by indirect means such as, for example, a statement that the average annual net profits over a given number of years are sufficient to pay the interest or dividends on the new capital several times over and that the net profits of the last year exceeded such average. In such cases the accountant accepts undesirable responsibilities and often constitutes himself a judge of circumstances upon which the investor himself should be placed in the position to form his own opinion by a full and frank disclosure in the prospectus.

Whilst it may be said that responsibility of the accountant in regard to prospectus certificates is largely a moral responsibility, he does incur the risk of having to justify before the courts the statements made by him in such a certificate. I can only recall one case (*Maynards, Ltd.* v. *Maynard and others*) in which action has been taken in respect of a prospectus certificate, and the certificate in that case was in the following terms:

> "We have examined the accounts of the forty-six retail businesses proposed to be acquired by your company, the majority of which have been established for several years. The accounts show that the businesses have been steadily increasing, the sales now being at the rate of £39,542 7s. 5d. per annum. We have also examined the accounts of the wholesale businesses carried on in connection with these retail shops, and find that the sales are at the rate of £17,795 11s. 7d. per annum, of which by far the greater portion is for goods supplied to customers other than the retail businesses, the total sales of the combined retail and wholesale businesses above referred to being at the rate of £57,337 19s. per annum. Owing to the absence of figures showing the expenses of some of the businesses we are unable to ascertain the exact net profit of the whole of them, but from our knowledge of the extremely profitable nature of the confectionery trade and from the facts disclosed during our investigation we are satisfied that the profits of the businesses are large, and that after payment of the interest on the preference shares there will remain a profit sufficient to pay a substantial dividend upon the ordinary shares."

The plaintiffs alleged that the accountants had knowingly made false statements as to the profits, but the court held that they had acted honestly and were honestly satisfied as to the correctness of their certificate, and the action against them was dismissed, but the mere fact that they were called upon to substantiate the opinions expressed indicates the danger in practice of constituting oneself an expert as to possibilities.

No one is free from the frailties which are the heritage of men and no one is infallible. But in the last half-century which has witnessed the rise and the development of accountancy as a profession there have been comparatively few reported cases in which it has been shown that practising accountants have failed in discharging adequately their onerous and responsible duties.

Accounting and Auditing in China

By Emil S. Fischer

In order to obtain a comprehensive understanding of accounting in China, attention must be given to the basic conditions which prevail in the far east regarding the possible field of activity of a foreign accountant. A brief historical digression may also aid the reader in clearly perceiving the situation of an alien practitioner in the orient.

The foreign expert or public accountant—or, in European terms, the chartered accountant, expert comptable or commissaire de comptes—generally finds his activity chiefly, if not entirely, among foreign merchants and industrial concerns established in China. The possibility of practising among Chinese concerns and institutions is limited, in fact practically negligible. The only occasion when it does occur is when the foreign interest in cases involving foreign loans of some magnitude causes the Chinese participants to attach to the enterprise a foreign auditor or auditing department to audit the moneys received and spent. In this category are placed the various government railways of China which in the aggregate comprise less than ten thousand miles of road, providing means of communication along the east coast of the middle kingdom. Therefore, the public accountant out here has little chance to obtain lucrative audit work from Chinese patrons, mainly because Chinese public offices and mercantile and industrial concerns all keep books according to Chinese style and habits, in Chinese characters and language—a language which no foreigner, with the exception of sinologues and masters of Chinese literature, has fully conquered. In this regard my own case is typical. I first arrived in China from America in 1894, and at that time among the foreign residents of Shanghai none would even attempt to learn Chinese except consular officers and assistants and a few others. However, I undertook the task for fully five years, with daily lessons in Chinese reading and writing. In spite of this training, although I can speak the ordinary patois with some freedom, I would be today incapable of making an audit, revision or investigation of Chinese kept books and vouchers without a native assistant. As a matter of fact, Chinese vouchers frequently come before me in my work for

foreign concerns and often my knowledge of the language permits me to pass them over in a general way, yet in many cases I need enlightenment from a Chinese clerk in order to be able to give my O. K.

It is necessary to go a little into the history of the interesting commercial life of the foreign merchant among the natives in order to obtain an understanding of the conditions out here. The present upbuilding of foreign business in China—a very slow process, indeed—dates from 1842, when after the so-called "opium war" Great Britain made a treaty with China which led to the opening of the first five treaty ports along the coast: Canton, Shanghai, Ningpo, Amoy and Fuchow. In addition to the opening of these treaty ports, the island of Hongkong was ceded to Great Britain, and this formerly small fishing village grew constantly bigger and bigger, until it has become the second or third largest transshipping port in the world. I shall not dwell upon conditions in Hongkong nor the present trouble of boycott by which shipping and commerce suffers there, as it can be only of a temporary nature.

Since 1842 Hankow and other leading ports, including Tientsin which for a long time has run second to Shanghai, have been opened by the Chinese government as places where foreigners are allowed to trade and to acquire property. There may exist now a hundred or more treaty ports but only a few of them are of sufficient importance to offer means of living to a public accountant under the conditions indicated earlier in this article. Before 1842 there was a reservation for foreigners at Canton and a similar center at the nearby Portuguese colony of Macao, where for several centuries aliens were forced to find their commercial contact with China. The first influx of foreigners made itself felt after the famous passage of the Cape of Good Hope by the Portuguese explorer Vasco da Gama in 1498, which brought as its sequence Spanish, Dutch and later British intercourse with the orient. So far as British efforts at trade with China were concerned, the famous East India Company developed business in Canton from about 1702 onwards, the French coming in 1728 and the Americans in 1784. Gradually also Scandinavian and Hanseatic towns took a share in the business. By the sea route active trade had existed between Alexandria and the far east before the Christian era, and trade by land had been carried on with Persia long before the time of Vasco da Gama.

Having scanned this gradual development of foreign intercourse and trade with China before 1900, or rather up to the outbreak of war between Japan and China in 1894, let us consider Shanghai, the most important of all Chinese treaty ports, which at that time possessed a foreign mercantile colony of only about 4,000 to 6,000 aliens. Today there are 20,000 to 30,000 foreigners in the Shanghai district in the midst of a Chinese population of more than a million. At that time there were proportionately less foreign residents in Tientsin, Hankow and Canton. These foreign merchants, in accordance with the treaties of foreign powers with China, were then all under consular jurisdiction, or—a better expression—under extraterritorial privilege obtained by treaties from 1842 onwards, and particularly by the expression of the Chefoo convention of 1876, by which no foreigner in China is subject to Chinese law as regards either his person or his property.

All these details will help clarify an explanation of the field of activity open in this section of the world to, say, an American public accountant. Even with the present considerable development of foreign trade in China, greatly augmented by the numerous new foreign business foundations during the last quarter-century and particularly since the end of the great war in Europe, the field of activity of the foreign public accountant is, generally speaking, peculiarly limited. In Shanghai, Tientsin, Hankow, Canton, Tsingtao or Harbin, places which have the largest foreign population in China, or even in Mukden, where there is a large colony of Japanese, the patrons in need of an accountant will nine times out of ten look for one who is of the same nationality as that under which the firm or enterprise is registered out here. This tendency is emphasized by rulings such as that recently instituted by the French government that auditors of French companies must be of French nationality, and the British ordinance of several years ago that managers of British business houses must be of British nationality. Therefore, when German interests are at stake a German accountant is preferred, because although most business houses out here keep books in English yet in a German house vouchers, correspondence or other documents written in German will continually appear and an auditor unfamiliar with the language will be as much at a loss before them as I am in auditing Chinese vouchers. All this shows how narrow the field is, and how necessary it is out here to be fully conversant with many languages. Then, too, there is the difficulty of ad-

hering in cases of need to all the laws which demand consideration. For instance, a case arose in 1914, when I was entrusted by the commercial attaché of the French legation in Peking with the administration of the estate of a deceased Swiss merchant who was registered there under French protection. This case plainly shows the variety of knowledge demanded, as many of the documents were not only in the French language, but also in German and in English and Italian and even in Russian. Collections of money had to be made from Chinese and foreigners, and the final division had to satisfy persons of many nationalities. Many other peculiarities might be pointed out relative to the work facing the public accountant in the orient. One peculiar condition to which an auditor out here has to give attention was mentioned by the writer at a convention of public accountants at Seattle in 1915. There I stated what attention the auditor must give to the variety of currencies prevalent in China, not only so far as his own district is concerned, but also to the hundreds of varieties of silver "tael currencies" in the large commercial towns of the Chinese empire. At times one finds exchange rates for the commercial taels prevailing, for instance, between Shanghai and Tientsin or Peking or Hankow and many other points where business houses in buying or selling products have to make or to receive transfers. I particularly spoke of commercial taels, the term by which taels in a general way are indicated in commercial transactions. But there is no fixed rule, and conditions between Tientsin and Peking may be such that instead of the so-called Kung Fa tael, that is, the high-grade commercial tael of Peking, some other low-grade commercial tael may prevail, and these two kinds of taels may mean a difference of touch of 2 to 7 per cent. The auditor making a final balance surely has to find out which kind of tael is to be considered in order not to show a too low or too high level of value to be approved in balances before him. There are in Peking, also, many other kinds of taels; for instance, the ministry of finance counts in the Ku-Ping tael of 1000/1000 fineness, and the customs administration counts in a similar fine product as agreed upon by treaties with foreign powers. All this may be very confusing when, for example, an agent of a New York fur firm remits moneys into Mongolia for the purchase of goods through Chinese channels. Such matters mean long-time practice; the conditions are such as I have not found elsewhere in my work in Brazil, or in the Argentine, or in Europe.

And even with all that has been said above, we are not at the end of the monetary difficulties which one has to face here in China, for there also exists a silver-dollar currency, chiefly used for the needs of smaller (though often in larger) transactions. Also, there is the subdivision of smaller silver coins of the dollar, which in the local market now figure, say, 12 ten-cent pieces plus 18 or 20 or more so-called "coppers" to the dollar. There are the copper coins, not those of olden days, but coins which are put on the market in millions by the government mints. Not long ago we used to get about 180 coppers for one big silver dollar; now, however, there is a prevalent rate of over 300 copper coins for one big silver dollar. This dollar, by a custom originating in former great imports of silver dollars from Mexico, still has the name of the "Mexican dollar," although now its origin is in China or Hongkong or Singapore, all three kinds running concurrently in the market. However, the Mexican dollar is attended by some advantages. Formerly when one went into the far interior of China, for instance, to the most western province of Szechwan, he had to carry along for his needs silver in bulk, taels-shoes of a weight of about 50 ounces. At present the situation is different, as is illustrated by my own experience of a trip in 1917 thousands of miles to the western sections of Szechwan into the Tibetan borderland and then into Kansu province. Wherever I went I could readily get along with Mexican dollars, although in certain sections the people would only accept one kind, and not all the kinds mentioned above.

All these coins and moneys which have been described are prevalent in accounts of foreign firms which the auditor may have to examine, with the exception that most minor transactions in small silver coins, in coppers and in "cash" (which will be described directly) are not generally considered in the principal accounts of a concern. Most firms allow expenditures involving these coins to be handled by a Chinese assistant, called the "comprador" with his force of "shroffs" and Chinese bookkeepers and other assistants, such as coolies. The comprador usually gets the privilege of gaining his own small exchange advantage for the handling of such moneys, and this advantage is commonly termed a "squeeze." It will be a long time before these conditions in China may be uprooted.

In addition to all the currencies whose general scope has been given, there exists one which no longer needs much considera-

tion: the "cash", which is a small, round, copper or brass coin with a small square hole in the center for stringing the pieces together. Nominally one thousand "cash" on strings were considered to be equal in value to one tael, or later to one Mexican dollar, but the rate fluctuates so, due to the multitude of usances in various parts of the empire, that it would be difficult to state what was its actual comparative value. Happily, this variety of currency, the daily-bread coin of the masses of the Chinese people, is disappearing more and more in the eastern or coast districts of China. The natives gradually have become accustomed to such coins as the coppers, and yet, when occasionally I have to cross a river at some distance from the coast, I will, of course, pay the boatman one, two or three coppers, while a peasant using the same ferry will pay one, two or three cash. But we no longer have seriously to consider such coin and the "squeezes" which could be made out of it.

During my activity as head accountant of the Deutsch-Asiatische bank in Shanghai (and it may be well to point out that most foreign banks out here have their own traveling auditors from home) from 1894 to 1899, I paid much attention to the study of what currency means in China, and before I left for my home in New York, I published a well received work, *Monnaies et Metaux Precieux en Chine*. Naturally I have always been interested in this question, and have therefore attempted to show its importance in the work of the foreign auditor in China.

The feeling among the few foreign public accountants out here is very friendly. The writer has had personal experiences which show a pleasant lack of jealousy or rivalry among the practitioners of many nations gathered together in the far east. There is, on the contrary, rather a fraternal feeling among the foreign accountants in China. They experience many common difficulties and are usually ready to offer aid to a fellow practitioner who needs it. I remember one occasion in particular when the influence of another foreign accountant proved of real value to me.

Lasting friendships have been formed between accountants whose acquaintance originated out here. The writer has, for example, maintained a constant and an intimate relationship with a practitioner, formerly a fellow worker in Tientsin, who has for many years been resident in Shanghai.

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A. P. RICHARDSON, *Editor*

EDITORIAL

Standards of Examination

During this month of May there will be held in many states and some of the territories of the United States examinations of candidates for registration as certified public accountants. The majority of the examinations will be conducted in coöperation with the board of examiners of the American Institute of Accountants. The minority will be tests prepared by state boards of accountancy. For the most part, therefore, questions and problems will be of a uniform standard, and that fair but high. In the states which yet remain outside the coöperative scheme the standards will be generally good, but naturally there will be a lack of uniformity and the significance of the certificates issued as a result of such examinations will depend upon the conditions of each individual state. It is interesting to remember that it was ten years ago this spring when the newly reorganized American Institute made its initial offer of its papers and the services of its examiners to state boards. Prior to that time there had been a few sporadic efforts to set up a uniform standard of examination, but without success. The early attempts to standardize examinations were futile largely because they originated in one or two states and the old distrust and envy of state for state prevented general acceptance of any plan of coöperation. Every state except the state of origin seemed to feel that the proposals must have some deep ulterior motive, not visible to the naked eye, but certainly reprehensible. A loosely knit association of examiners was ineffective and passed almost silently away. Endeavors to establish little groups of coöperating states seemed rather hopeful for a time, but they too lapsed into failure. In a word, there seemed to be no way on which even two states could march in step, and it looked as though the certified public accountant examination would continue, as long as it continued at all, to be a complex congeries of individual and

not always competent notions limited in variety solely by the number of state laws. The great difference in requirements by the several state boards was one of the most destructive agents in the threatened debacle of the whole C. P. A. structure, although it was not by any means the only weakness. There were questions of personality, knowledge or its want, narrow-mindedness, ostentatious pedantry, crass incompetence and some other things which in the early years interfered in some places with the desired progress of the movement for control of the new profession. These all must be remembered if one would understand the history.

The Obstacles Surmounted

When matters were in this debilitated condition the Institute was formed, partly because it was apparent that the plan of decentralization was not sound and partly to set up a standard entirely within the control of the profession itself. In the first year of its reorganized existence the Institute began to conduct its own examinations for admission and then as a logical corollary to offer its services to state boards which might care to take advantage of the opportunity to approach a national standard. In the years intervening between 1917 and 1927 the plan of coöperation prepared by the Institute has remained practically in its first form. A few minor changes have been made, but the substantive part of the plan endures. Two or three state boards which have participated in the plan have relinquished it, but the steady adherence of a majority of the states is conclusive proof of the merit of the fundamental idea. What a state or a group of states could not effect is possible when the moving spirit is an organization not associated with any one state. There was no reason to suspect that the Institute was animated by any unworthy motive in its offer of assistance, and so the plan of coöperation was adopted with a rapidity and to an extent which was somewhat astonishing in the light of earlier experiences. Every accountant and accounting student in the country today probably is more or less familiar with the standard form of examination prepared by the Institute, but sometimes the record may be forgotten. Now, ten years after the first coördinate examinations the standards throughout the country have reached a fairly satisfactory plane. Even in states where there was a low level of examination and where the plan of coöperation has not been adopted there has been a marked improvement. The force

of example is not negligible. In a few other states where the plan has not been accepted there have been fair standards almost from the beginning. The day when any state could be cited as a synonym for weak and meaningless certification of accountants is almost over. There may be a soft spot here or there, but convalescence is at work. It is really a noteworthy accomplishment which the profession has to its credit that it has been able to recover in a remarkably short space of time from what looked like a case of pernicious anæmia. The most potent ingredient of the tonic which is effecting a cure is standard examinations.

The Fortieth Anniversary

While we are indulging a little in retrospect, it is appropriate to refer to the importance of the annual meeting of the American Institute of Accountants to be held next September. It will mark the fortieth anniversary of national organization and there will be much review of the past and much eulogium of the present. In 1887 a few men formed a society to which they gave the rather high sounding title "American Association of Public Accountants." They represented the profession in only a small part of the country but perhaps their choice of a name was prophetic. At any rate it was not long before the membership had increased and the sphere of influence had grown. At the end of 1905 it was truly a national body and has so continued with ever growing effect. The change of name in 1916 was made necessary by a radical reform in the rules for admission and discipline. This year the profession will celebrate its fortieth corporate birthday. At such times the temptation to exult unduly is almost irresistible. The development has been little less than amazing; ethical ideals flourish where there was not even an idea of ethics; the public begins, reluctantly perhaps, to admit the indispensableness of the accountant; the financial world is awaking to the need for impartial investigation; the rewards of practice are impressive; the new vocation is established—and all that has been done in forty years. The greater part of it has come about in less than thirty years. Any accountant inclined to glory in the facts is pardonable perhaps if he goes a little to excess. It is hard to be conservative about an evident miracle of progress. But forty years is not even a life-time in this century. The profession has done very well and deserves great credit, but there are more years to come than have passed

and the truly thrilling thought which must come to every contemplative accountant is this: If from nothing there has grown in two score years so strong and splendid a profession, who can even faintly forecast the development ahead? In 1967 the practitioner will be able to look down upon us of this generation with much the same air of friendly condescension that some of us today bestow upon the smallness of the numbers in 1887. And as to the nature and scope of the work forty years hence—that is entirely beyond prediction or foresight. It may be that the most extravagant expectations will fall utterly short of the reality.

An Ideal is Always Necessary

The possession of an ideal is one of the great blessings of life, whether in trade, profession, the nation, the family, or in the personal spheres of morals and religion. Accountants have been more richly blessed than most men because they have come lately into the world and have been able to select their ideals after humanity and civilization have been carrying on for centuries the process of selection and rejection in the realm of the ideal. A gentleman knows pretty well today what he should set before his mind's eye as the most to be desired. He may not be absolutely right—we shall not be able to decide about that in this world—but at least he has the experience of the fathers before him and he is to blame if he choose aught but the best. It took the law a millenium or two to determine what should be its professional ideal—and sometimes one wonders if it has not been temporarily laid aside. Medicine, too, has been dreaming of ideals since Hippocrates, and it seems that the great majority of practitioners in that noble profession are striving to reach perfection. Accountancy has its ideals as well, and they have been wisely chosen. We have mentioned the fortieth anniversary of the founding of a national society, but it should be added that the wonderful progression has been due chiefly to the wisdom of the early leaders, who, seeking an ideal, took the highest form of professional duty and proficiency. Of course we have not attained perfection. Of course there is a lot of miserable stuff masquerading in the guise of accountancy. Of course there are moments of discouragement and the thinkers wonder whether the ideal is not fleeing faster than it can be pursued. That is one of the supreme attributes of an ideal—it will never be overtaken, for then it would become actual, no longer ideal. It

hangs ever beyond our reach and so we are never satisfied, which is a means of salvation, for the satisfied man is ready for interment. It shows us always a glimpse of what should be, and thus it keeps alive that healthy disgust with the worthless and inane which leads to a striving for the good and true. Someone said not long ago that the professional ideal was unattainable and therefore should be ignored, which is very much like saying that an ideal is ideal. Those who ponder the subject deeply may wonder what kind of a thing an ideal may be in the minds of any who despair.

Lawyer and Accountant

At one of the regional meetings of the American Institute of Accountants not long ago an eloquent and learned member of the bar described what he considered would be an ideal relationship between the lawyer and the accountant. The picture which he painted in bright colors made a great impression upon all who were fortunate enough to be present, and one of the high lights is that there is one ideal which may become actual without losing any of its beauty. The speaker was a representative of that noblest tradition of the bar which sets loyalty to the code above any other consideration. The title of the address is forgotten; perhaps it was one of the stereotyped topics which one always expects to see on a programme of an accountants' meeting. It may even have been so banal as "The accountant and the lawyer." But, whatever the subject assigned to the speaker, he deserted it promptly and set out on an original venture. What he was anxious to make plain was the conviction which had forced itself upon him that the lawyer as a part of modern business was falling into grave danger of making himself ridiculous in the public eye and of failing to serve his client to the best of his ability, because of his unwillingness to admit that there are some things which even a lawyer can not be expected to know and indeed does not know. The speaker explained the imperative duty of the lawyer to bring to the assistance of the client the best mental ability obtainable, even if that involved the introduction of other men with different kinds of minds and knowledge. He deplored the absurd narrowness of the smug legalist who professes to look askance at the pretensions of any human being whatsoever to know anything on any subject without a training in law and admission to the bar. In fact it appeared in the course of the speaker's remarks that he

was bold enough to believe that the time was coming when the lawyer might cease to dominate all legislation in this greatly over-legislated country and when the legal profession would be content to practise law as it did before representative government had given the legally trained legislator his present power and authority. Such treason as this is noteworthy for two reasons: first, because it was uttered by a lawyer who evidently knew his subject, and, second, because it was so startlingly frank and, to a lay mind at least, so utterly true.

Where the Accountant is Needed

What the speaker had chiefly in mind apparently was the ridiculous attempt of some lawyers to deal with questions which are founded solely upon accounting principles. For example, it is preposterous for anyone who is not familiar with accounting to conduct unassisted an examination of an expert witness who knows accounts quite as well as the lawyer knows law. Nearly every accountant has memories of absurd questions asked by lawyers during examinations—some of the questions so absurd that the dignity of the court was upset. Then there is the preparation of cases to be presented in the prosecution of claims for refund or relief before the various commissions and committees charged with the adjudication of tax disputes before they reach the courts, and later before the courts themselves. At least ninety per cent. of the disagreements between the taxing power and the taxpayer turn upon questions of accounts, and even the other ten per cent. are not wholly divorced from the accounting records. Another dangerous pitfall for the lawyer is the accounting technicality involved in consolidations and other corporate changes which call for an intelligent grasp of the books of record. Some of the errors into which lawyers have fallen in their desire to do all and to be all are almost incredible—an office boy of tender years might be expected to know more of the meaning of figures than the legal mind seems sometimes to have grasped. It was the recollection of such mistakes, no doubt, that led the speaker to condemn in unqualified terms the pseudo-omniscience of some lawyers. One wonders what the men guilty of queer misconceptions of accounting questions would say if an accountant were to essay the rendering of legal advice and assistance to every client. There would be an uproar and we should hear much about the outraged majesty of the law—if anyone doubts the certainty of such protest let him turn to

some of the laws enacted within comparatively recent years by lawyers for the protection of lawyers. They are very jealous of their prerogative. These comments are not intended to convey the notion that the accountant or any other untrained person should be permitted to dabble in the law and imperil the rights of litigants or other clients. It would be tragic if legal practice were thrown open any wider than it is at present. Indeed, the restrictions might be strengthened and narrowed without injury to the nation.

Two Professions, Not One

The truth of the matter is—and this is what the speaker was saying—that accountancy and law are two things. Ever the twain shall meet, but never shall they mingle, without injury to both. This is the view of the question which appeals to the best men in both professions. Scores of lawyers are refusing to undertake cases which are concerned purely with accounting, and hundreds have seen the wisdom of consulting accountants upon the points of technical accounting which arise in practice. So, on the other hand, the wise accountant calls upon the lawyer for legal advice and assistance whenever the need appears. Each profession can help the other and there is no earthly reason why they should not labor harmoniously. All this has been said so often that it might seem unnecessary to repeat it, were it not that the force of the argument appears to have gone astray. Concord between the professions is still far from universal or even from common. But it was something much more definite that the speaker whom we have been quoting had in mind. He reviewed the unfortunate misunderstandings briefly, but then proceeded to draw an analogy between the professional relationships of the lawyer and the accountant and those of the barrister and the solicitor under the British system. It is a pity that the exposition of this comparison was lost—the speech was ex tempore and there was no reporter—but the idea is one that could be elaborated by anyone familiar with the matter. The salient points may be summed up in the statement that the solicitor or attorney prepares the case, arranges for the appearance of witnesses and does practically everything else except to conduct the prosecution or defense in court: that is the barrister's duty. In other words, the solicitor (this term must not be confused with the designation applied sometimes, usually in a contumelious sense, to salesmen or canvassers) is the munition maker and

the barrister is the artillery. The one prepares what the other proposes. We have had no such distinction in the practice of law in this country, but there seems to be a tendency to adopt it in a modified form, especially in the engagement of adept trial lawyers to conduct cases in which the prestige of a well known name and the exceptional forensic ability of a leader of the bar are deemed necessary as a supplement to the ingenuity of the attorney. Even in such instances, however, the attorney usually participates in presentation before the court.

Solicitor and Barrister

There is a great deal of merit in the suggestion that the solicitor-barrister relationship should be established between the accountant and the lawyer. Take, for example, the prosecution of claims before the board of tax appeals, a commission which has pronounced judicial leanings. It is an old story that the accountant who attempts to prepare and present a case before the board is liable to all manner of difficulty and distress because of the apparent requirement that the law of evidence must prevail. The lawyer, of course, is not the proper person to discover and set in array the figures upon which the case depends—he would not know where to begin—but once the foundation is made ready, the accountant may not be the proper person to adduce the arguments. This statement may excite the wrath of some accountants who believe that the board of tax appeals has no right to arrogate to itself the status of a court, and with those who entertain such sentiments it is hard to differ; but we are trying to discuss conditions as they exist, not as perhaps they should be. There is a steadily increasing disposition on the part of accountants to call in lawyers to do the actual pleading, and when the accountant and the lawyer thus collaborate it is undeniable that the best results are probable. Here we find already an application of the theory that the accountant is rather in the position of the solicitor and that the lawyer really acts as a barrister. The only reason for the unwillingness of some accountants to adopt this expedient seems to be the uncertainty as to what is the true standing of the board of tax appeals. When cases come before the committee on appeals and review in the treasury department, it is not necessary to rely upon legal assistance, because there one encounters a matter-of-fact method of seeking a fair settlement; but perhaps it is not practicable to

carry on the work of the board of tax appeals in a direct and informal way. At any rate the experiment has not been tried. As the conditions now exist the accountant is at a disadvantage, and so he is coming to depend more and more upon his cousin, the lawyer, to manage the case in conformity to the complicated system of a quasi-judicial commission. What seems to be necessary where the board of tax appeals is concerned is certainly necessary when matters come before a duly constituted court of law. There the accountant is compelled to have legal advice and assistance and he never hesitates to comply with the requirements. In most cases, however, it is the lawyer who calls for the accountant to prepare figures and give evidence. Nine times out of ten the matter originates in the lawyer's office.

How They May Coöperate

We find, then, that in effect the relationship of the solicitor and the barrister is closely parallel to that of the accountant and the lawyer in some cases. The trouble is that this is not often so. Inter-professional jealousies and misunderstandings bar the way of further progress, but the obstacles will be overcome and it is not hoping too much to believe that the helpfulness of one profession to the other will increase rapidly in the coming years. If the lawyer will remember that the accountant is not trying to steal his practice; if the accountant will learn that the lawyer is not attempting a like larceny of the accountant's practice; and if both professions will agree to do what each is properly qualified to do and not to roam about all over the professional countryside—if these things can be achieved, there will be comfort and peace for everyone concerned. The man who can prepare a case should prepare it. He who can present it should do so. And that rule applies two ways. If it is the duty of the accountant to call for legal aid when a matter is going into court, it is equally the duty of the lawyer to call for accounting help when a matter is going before the accountants' court, where judge and jury are the shareholders, the directors, the public. In such a case the lawyer should act somewhat as the solicitor and the accountant as the barrister. The accountant is the best fitted to present a financial case before the court of business men. He may be engaged by the attorney who has paved the way to the conclusions, but his engagement is like that of the barrister. Does this seem a stretching of the analogy?

Perhaps it is today, but it is not so unreasonable as some may think it. Turn to the advertisements of stocks and bonds issued or about to be issued by bankers. There one will find that the legal factors have been approved by such-and-such a firm. About half the time it appears that the accounts have been audited by so-and-so. If the proper sense of comparative importance were followed the accountant's report would be the essential. The legal questions are vital, but of what use is a perfectly legal plan if there is no value upon which the plan may be made effective? Speculations about the closer fellowship of the accountant and the lawyer are attractive and soon lead into the realm of the improbable, but it is evident that the relationships are improving and the suggestion of a bond such as that between the solicitor and the barrister is worthy of more than a passing thought. The fact that the proposal bears the approval of an eminent member of the bar is not to be overlooked. The older profession is rather toplofty at times, but if the positions were reversed would the accountant be innocent?

Ratio of Seniors to Juniors

Attention has been directed lately to a change which is taking place in some accounting offices, and perhaps in most, in the ratio between senior and junior accountants. It is said that each year there is proportionally less demand for junior men and that the number of seniors remains practically constant or increases slightly. Where in years past there were, let us say, two juniors to every senior there is now only one, and quite often the seniors outnumber them. If this be true there must be some reason for it other than the theory that the young men are growing older and more efficient and that few new men are coming forward. One thing which may have a bearing on the question, but not often, is that the employer finds it more profitable to send seniors on assignments, as there is a larger margin of fees for men of the higher class. To this argument the obvious reply is that the client will not encourage the employment of costly assistance if a cheaper kind is adequate—and the client is the determining factor in such matters. The real reason for the change is the great progress which has been made by nearly all companies of any magnitude in the systems of internal check and in the application of sound theories of management. There was a time when it was necessary to do the most elementary work for

the client and then the junior accountant was much in demand. A great host of things fell to the lot of the junior and he did them well, because no vast experience or profound knowledge was required. When accountants had introduced reforms, when tax laws compelled at least a semblance of accuracy in the books and when the companies themselves saw the wisdom of new policies and set their own houses in order, much of the kindergarten work came to an end and so the junior was deprived of part of his reason for being. There is now and always will be room for many young men of the right kind. The profession's normal growth will demand recruits both in the senior and in the junior grade, but the ratios between the two classes are changing and, as time goes on, there does not seem much probability that the trend will be reversed. What the client now requires is the service of competent and experienced men who can take up the work at the point to which it has been brought by modern methods within the client's own organization. The new conditions are significant of health and progress, and the professional accountant must rejoice at the relief from dull routine which was ever irksome to the man of initiative and vision.

Income-tax Department

EDITED BY STEPHEN G. RUSK

Senate resolution 304, adopted without comment by the 69th congress, reads, in part, as follows:

> "Whereas it has become the usual practice of corporations, in order to protect stockholders from the payment of income taxes, to declare stock dividends; and
>
> "Whereas this procedure enables corporations to acquire competing plants, and in this way avoid the provisions of the anti-trust laws; . . ."

As a result of such astute reasoning the federal trade commission was directed to ascertain and report to the senate the names and the capitalization of corporations that have issued stock dividends, together with the amount of such stock dividends since the decision of the supreme court holding that stock dividends were not taxable, as well as prior to said decision.

Congress, or at least a few of its members, apparently can not rid itself of the idea that the directors of corporations spend a great deal of their time in thinking up ways to avoid the distribution of accumulations of earnings to the stockholders for the sole purpose of protecting these stockholders from the payment of surtaxes on dividends.

It would be interesting to know how "usual" is the practice of declaring stock dividends with the purpose of evading the provisions of section 220 of the several revenue acts. It is probably more accurate to say that in cases of the declaration of most stock dividends the directors are actuated by purposes quite different from the protection of their stockholders from the payment of taxes on dividends. The usual reason is that because of the increase of the business the declaration of other than a stock dividend would so deplete the working capital as to render it necessary to borrow needed funds to carry on. When it is remembered, too, that an income made up largely of dividends sustains a total tax much less than income derived in any other way except from tax-free bonds, it will be readily apparent that it is not the "usual" practice of corporations to distribute stock dividends to avoid the taxation of dividends.

It is trite to say that the recipient of a stock dividend is no richer upon its receipt than he was before. If the market of the stock increases and he sells any of the stock so received, the stockholder then pays a normal tax as well as a surtax upon the profit of the sale. If he takes his stock so received, and borrows money on it, he is no richer. In view of these generally known facts it is a cause of wonder that some congressmen still consider the distribution of a stock dividend as a sinister move against the interests of the government and of the general public.

A review of the returns of corporations for the year 1925 revealed the fact that a surprisingly small percentage of them were conducted at a profit. If this is the case for many years and if the fact should become known to congress, it is barely possible that that body will look with more tolerance upon corporations and their activities and cease to believe it can judge all corporations by the acts of a few of them.

SUMMARY OF RECENT RULINGS

Collection by distraint of income taxes imposed by the revenue acts of 1916 and 1917 is barred by section 250 (d) of the revenue act of 1921 five years from the time the return was filed, although the taxes were duly assessed within the five-year period provided by section 250 (d) of the act.

Distraint is a "proceeding" as that term is used in section 250 (d) of the revenue act of 1921.

The intention of congress by section 250 (d) of the revenue act of 1921 was to protect taxpayers against any proceedings whatsoever for the collection of tax claims not made and pressed within five years of the time the return was filed. (United States supreme court, *Bowers* v. *New York and Albany Lighterage Company*.)

Real estate is part of the taxable estate of a decedent owner under the 1921 act, though the state statutes do not make it liable for expenses of administration. (Court of claims of the United States, *Steedman and Edmunds* v. *United States*.)

In the absence of a bill of exceptions and statement of the evidence, the judgment of the lower court, involving invested capital, was affirmed, its findings of fact and conclusions of law constituting a sufficient written opinion and supporting its judgment. (Circuit court of appeals for the seventh circuit, *P. H. and F. M. Roots Company*, v. *United States*.)

Amount received in 1919 on cashing in insurance policies on which all premiums had been paid before March 1, 1913, is taxable on excess only over value on latter date, being the then present value of what they would be worth at maturity, the amount paid from earned surplus being taxable as dividends, the remainder being subject to both normal and surtaxes. (United States district court, W. D. of Kentucky, *Alexander* v. *Lucas, collector*.)

Invested capital under the 1918 act may include cash value of notes paid for stock in good faith, although the state law provided that no stock should be issued for notes, such notes nevertheless being unforceable. (Circuit court of appeals for the second district, *Bowers, collector* v. *Max Kaufman & Co., Inc.*)

The interest accruing from sums received by a cemetery company from purchasers of lots and by it paid into a perpetual maintenance fund does not constitute taxable income to the cemetery company. (United States district court, W. D. of Missouri, *Troost Avenue Cemetery Company* v. *United States*.)

Transfer in trust, leaving no interest in grantor, made a few months before his death, to accumulate the income for thirty years, then principal and interest to be divided among grantor's children or their issue, not claimed made in contemplation of death, was not one to take effect at or after death. (Supreme court of the United States, *Executrices of estate of Gustav E. Shubert* v. *Allen, collector*.)

A bank, calling itself a partnership, having delectus personarum, having no entity other than its members, and managing its business through its cashier, who acted for himself and as the agent for his partners, is not taxable as a corporation under the 1918 act, although the retiring or death of a member, transfer of a member's interest, or the coming in of a new member does not cause a discontinuance of the business. (United States district court, S. D. of Illinois, *The Walnut Bank* v. *United States*.)

TREASURY DECISIONS

T.D. 3984, February 24, 1927

ARTICLE 1011: Compromise of tax cases.

Income and excess-profits taxes—Revenue acts of 1916 and 1917—Decision of circuit court of appeals

TAXES—COMPROMISE—SUIT

Where a taxpayer pursuant to section 3229 of the *Revised Statutes* offers a certain sum in compromise of taxes, penalties, civil

and criminal liability, and the offer is duly accepted by the authorized officers of the government, an action at law can not thereafter be maintained to recover back a part of the taxes alleged to have been illegally assessed and collected.

The following decision of the United States circuit court of appeals for the fifth circuit in the case of *Alexander S. Walker, formerly collector of internal revenue*, v. *Alamo Foods Co.* is published for the information of internal-revenue officers and others concerned.

United States Circuit Court of Appeals for the Fifth Circuit

Alexander S. Walker, formerly collector of internal revenue, plaintiff in error, v. *Alamo Foods Co., defendant in error*

Error to the district court of the United States for the western district of Texas [January 4, 1927]

Walker, circuit judge: This was an action by the defendant in error, the successor of the San Antonio Brewing Association (herein called the plaintiff), against the plaintiff in error, former collector of internal revenue (herein called the collector), for the recovery of the sum of $237,128.53 with interest thereon. By stipulation of the parties a jury was waived, and the court made findings of facts and conclusions of law, and thereon judgment for the amount sued for was rendered. The following statement indicates the circumstances of the payment of the principal amount sought to be recovered: In July, 1918, two criminal indictments were returned by the federal grand jury at Austin, Texas, charging C. T. Priest, plaintiff's vice-president and general manager, with knowingly participating in filing false and fraudulent tax returns on behalf of the plaintiff for the year 1917. Prior to August 14, 1919, the commissioner of internal revenue made an assessment against plaintiff in the sum of $370,184.53, for additional income taxes for the year 1916, for income and profits taxes for 1917, and for penalties. On the last-mentioned date the collector caused to be served on plaintiff notice demanding payment within 10 days of the amount of that assessment. Thereupon the plaintiff applied to the collector for an extension of time for payment to enable it to file claims for abatement and to secure hearings thereon before the commissioner of internal revenue. Upon the collector refusing to grant such extensions unless plaintiff executed a conveyance of all its property to a trustee, conditioned to pay the assessed taxes and penalties if the request for abatement was not granted, plaintiff executed such conveyance. Thereupon plaintiff filed claims for abatement of the taxes and penalties assessed. On November 13, 1919, the commissioner notified plaintiff that the sum of $27,486.78 was abated, and that the amount of the assessment was reduced to $342,697.75. Thereupon the collector demanded payment of the just stated amount. When this occurred the plaintiff requested the collector to postpone enforcement of the trust deed to enable plaintiff to communicate further with the commissioner with a view to the latter reconsidering the controversy. The collector complied with this request. During the period of several months thereafter representatives of the plaintiff had numerous conferences with the officials at Washington in the effort to bring about a reduction of the assessment. Even before that assessment was made a representative of the plaintiff notified the department that the plaintiff would prepare and submit a proposition to settle and compromise the matters in question, both criminal and civil. In November, 1919, after it was disclosed that plaintiff could not obtain a reduction of the assessment, at a conference in Washington between officials and the representative of the plaintiff who had knowledge of all the pertinent facts, it was agreed that plaintiff would make an offer of compromise and settlement on terms stated, which included a 50 per cent. reduction in the penalties assessed and a dismissal of the above-mentioned indictments. Pursuant to that understanding the plaintiff, in December, 1919, and January, 1920, made deposits, the aggregate of which

made up the amount proposed to be paid by plaintiff, and the plaintiff submitted the following written offer, dated February 1, 1920:

"Collector of Internal Revenue,
Austin, Tex.:

"The undersigned, The San Antonio Brewing Association, seeking the benefits of section 3229, United States *Revised Statutes*, hereby tenders the sum of $318,039.70 in payment of all income and excess-profits taxes, and in compromise of all penalties and other civil and criminal liabilities of said association and its officers growing out of internal-revenue taxes due for the years 1916 and 1917.

"San Antonio Brewing Association,
[Signed] "By C. T. Priest, *Vice-president.*"

That offer was received in the office of the solicitor of internal revenue in May, 1920. After the acceptance of this offer had been recommended by the commissioner of internal revenue and that recommendation had been approved by the secretary of the treasury and by the attorney general, the solicitor of internal revenue, on August 23, 1920, by the following written communication, advised the plaintiff of its acceptance:

"San Antonio Brewing Association,
San Antonio, Tex.:

"Sirs: The commissioner of internal revenue has considered the proposition submitted by you on May 14, 1920, through the collector of internal revenue at Austin, Tex., as a compromise of liabilities on account of filing false and fraudulent income and excess-profits tax returns for the years 1916 and 1917, and has decided, with the advice and consent of the secretary of the treasury and the concurrence of the attorney general, to close the case by the acceptance of the following terms:

"$318,039.70 in payment of all income and excess-profits taxes and in compromise of all penalties and all civil and criminal liabilities of the San Antonio Brewing Association and its officers growing out of internal-revenue taxes due for the years 1916 and 1917.

"Respectfully,
[Signed] "Wayne Johnson,
"*Solicitor of Internal Revenue.*"

Thereupon the above-mentioned indictments were dismissed. In August, 1923, claims for the refund of the additional taxes and penalties involved in the above-mentioned compromise and settlement were filed. In December, 1923, those claims for refund were rejected for the reason that the controversy as to the subject of them had been settled. This suit was brought on June 10, 1924, the principal amount sued for being the amount paid as above stated less the part thereof which was admitted by plaintiff to have been properly paid. The court's conclusions of law included one to the effect that said payments by plaintiff and said attempted compromise were made under duress, and that, because of such duress neither the payments nor the compromise are binding on the plaintiff. It is disclosed that the only finding of fact upon which the just mentioned conclusion was based was the following:

"That the proposal of compromise hereinbefore found, was not made voluntarily and that the taxes and penalties paid in pursuance thereof were not paid voluntarily, but that such proposal and the payment of such taxes and penalties were made only by reason of the threat made by the collector to distrain the property of the association if the taxes and penalties were not paid within ten (10) days after the notice by the collector demanding such payment, and because of the threat of the collector to make sale of the association's property under the deed of trust or mortgage given by the association to secure the payment of such taxes and penalties if not promptly paid, and because of the

pendency of the indictments against C. T. Priest and the threat to prosecute the same."

The facts of this case do not call for the application of the rule that money paid to prevent the enforcement of process for the collection of taxes not legally due or owing may be recovered if the making of such payment was accompanied with notice that the party making it did not do so voluntarily. (*Ward* v. *Board of County Commissioners of Love County,* 253 U. S., 17; *Gaar, Scott & Co.* v. *Shannon,* 223 U. S., 468; *United States* v. *New York & Cuba Mail S. S. Co.,* 200 U. S., 488; *Railroad Co.* v. *Commissioners,* 98 U. S., 541.) There is a material difference between a payment so made and a payment made pursuant to an agreement of compromise of the matters in dispute. A party against whom taxes have been assessed is at liberty to make or accept or to refrain from making or accepting an offer of compromise. The making of an offer of compromise is a voluntary act, and the contract resulting from its acceptance is binding on a party unless his consent to the contract was illegally obtained. (*Ostrum* v. *City of San Antonio,* 71 S. W., 304; *Palomares Land Co.* v. *Los Angeles County,* 146 Calif., 530; *Lee* v. *Inhabitants of Templeton,* 13 Gray, 476.) The opinion in the case of *Swift Co.* v. *United States* (111 U. S., 22), which was invoked by counsel for the plaintiff, and the opinion in the same case on a previous appeal (105 U. S., 691), recognize the distinction between a coerced payment and a payment made pursuant to a contract or agreement. It clearly appears from those opinions that the plaintiff in that case would not have been entitled to recover if an agreed settlement of the matters in controversy had been proved. Furthermore, a material difference between that case and the instant one is indicated by the following statement made in the opinion rendered on the second appeal.

"No formal protest, made at the time, is, by statute, a condition to the present right of action, as in cases of action against the collector to recover back taxes illegally exacted."

The payments now in question were made, not in compliance with any official demand or statutory requirement, but in pursuance of an agreement to which the plaintiff was a party, and without protest or notice that in making or complying with that agreement the plaintiff acted otherwise than voluntarily. The making of that agreement was authorized by the statute providing for the compromise of any civil or criminal case arising under the internal-revenue laws. (R. S. 3229, Comp. Stat., sec. 5952.) A compromise by which the authorized representatives of the government agreed to take, and the plaintiff agreed to pay, a less sum than had been assessed against the latter had the effect of extinguishing the controversy between the parties to the contract. (*Little* v. *Bowers,* 134 U. S., 547, 556.) The matters which were in controversy between the parties to the compromise before it was made are not subject to be reopened if the compromise was binding on the parties, and the question whether it was binding is determined by rules applicable to contracts generally. A payment made pursuant to a contract can not be recovered back without annulling or canceling the contract, and that can not be done unless the payer's consent to the contract was illegally obtained, or without his taking prompt action to annul or avoid the contract and restoring the status which existed before the payment was made. The party seeking to get back what he has paid can not retain the benefits of the contract and escape its burdens. (*McLean* v. *Clapp,* 141 U. S., 429; *Grymes* v. *Sanders,* 93 U. S., 55; *Multnomah County* v. *Title Guarantee & Trust Co.,* 46 Oregon, 523.) The indictment mentioned having been dismissed pursuant to the compromise agreement, it is obvious that it was impossible to restore the status which existed before that agreement was made. In the situation which existed between the date of the making of the demand that plaintiff pay the amount of the assessment finally made and the date of the compliance with the compromise agreement it was open to the plaintiff either to pay under protest the amount assessed and sue for the whole or any part thereof claimed to have been erroneously or illegally assessed or collected. (Comp. Stat., sec. 5949), or to avail itself of an opportunity to settle by compromise the matters in controversy. It chose the last-mentioned alternative. By this suit it claims that it was as free to attack the assessment

as it would have been if it had chosen the other alternative. No finding made indicates that in making the compromise the plaintiff acted without full knowledge of all the circumstances, or that it was influenced by any constraint except such as resulted from the facts that when the agreement was made the above-mentioned indictments against one of its officers was pending and the collector had means of promptly enforcing collection of the assessment made. It well may be inferred that when the statute authorizing the compromise of any civil or criminal case arising under the internal-revenue laws was enacted it was contemplated by the lawmakers that it would frequently happen that at the time of the making and acceptance of an offer of compromise an assessment of taxes claimed to be due would be presently enforceable and there would be pending a charge of criminal misconduct with reference to such taxes against the party claimed to be liable therefor or a representative of such party. Officials rarely would be justified in exercising the power to compromise criminal cases if the pendency of a duly made criminal charge sought to be included in a proposed compromise has the effect of enabling the party seeking the compromise to repudiate the compromise or treat it as a nullity except as to its result in getting rid of the criminal charge. Certainly a compromise agreement to pay a stated sum is not kept from being binding on the party agreeing to make such payment by the fact that that party knew that the payment by him of a greater sum could and would have been coerced if he had not so agreed. (*Savage, Executrix,* v. *United States,* 92 U. S., 382.)

The court's ruling was to the effect that the plaintiff was entitled to treat the compromise agreement as a nullity and to maintain an action to recover back the amount wrongfully assessed, because at the time that agreement was made plaintiff was subject to be coerced to pay a larger sum than the one it agreed to pay and its representative was subject to be tried under the indictments against him, though the plaintiff did not promptly take action to avoid or annul the compromise agreement and could not restore the status which existed before that agreement was made and complied with. We are of opinion that the ruling was erroneous, and that on the state of facts found plaintiff was not entitled to recover back the whole or any part of the sum it paid in pursuance of the compromise agreement. The just stated conclusion makes it unnecessary to consider other grounds on which the judgment under review was challenged.

The judgment is reversed, and a judgment will be here rendered dismissing the suit, with costs against the defendant in error.

Reversed and remanded.

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, 1926, 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 19, 1926, 9 a. m. to 12:30 p. m.

(Each satisfactory answer is entitled to 10 points)

Answer two questions on negotiable instruments, two on contracts, two on corporations, two on federal income tax and one question each on partnership and bailment.

Classify each answer under its proper heading, as proper classification will be considered as part of a correct answer.

Set forth the reasons and legal principles involved in each answer.

1. Norton, owner of a pulp mill in Maine, negotiated with Burns for the sale of the mill. Burns lived in New York City, where Norton arranged to meet him. Norton left Maine on October 2nd, met Burns in New York and on October 5th they executed the contract of sale. On October 4th the mill was destroyed by fire, a fact unknown to both parties when the contract was signed. What are the rights of the parties?

Answer:

Contracts. Norton is excused from performing and Burns can recover back any money he has paid. Where the parties purport to sell specific property, and the property without the knowledge of the seller has wholly perished at the time the agreement is made, the agreement is void. Sometimes the result is put upon the ground of impossibility, sometimes upon the ground of mistake, and sometimes on the lack of mutual assent owing to the mistake.

2. One of three members retires from a firm, the two remaining members assuming, by written agreement, all responsibility for the then outstanding debts. Before these debts are paid a combination of unfortunate circumstances renders the new firm insolvent. Can the retiring partner be held for any part of the debts?

Answer:

Partnership. The retiring partner before retiring was individually liable for the partnership debts existing at that time. The agreement on the part of the remaining partners to assume liability for the debts does not relieve the retiring partner from his liability for the old firm debts, because the creditors were not parties to the agreement.

3. What is a common carrier's liability for goods he carries, and what conditions free him from the liability?

Answer:

Bailment. Under the common law, a common carrier is responsible for the safe transportation and delivery of goods received by him for carriage and can

justify or excuse a default only when occasioned by an act of God or the public enemy.

4. A has, among other items of income for 1925, the following dividends:

United States Steel Corporation	$350
New York Central Railroad Co	175
Kerr Lake Mines, Ltd. (a Canadian corporation operating entirely in Canada)	125
Corporation (a British holding corporation whose sole income for five years past was dividends from a domestic corporation)	250
American Tobacco Company	300

A's total net income exceeded $12,000. How would you treat the above dividends in preparing A's federal income-tax return for 1925?

Answer:

FEDERAL INCOME TAX. All the dividends should be included in A's gross income and are subject to surtaxes. In determining his net income for the purpose of the normal tax, in order to avoid double taxation, A can deduct as a credit from his gross income the dividends from the American corporations and the dividend from the British holding company. The Kerr Lake Mines, Ltd., dividend of $125 is subject to the normal tax as well as the surtaxes.

5. You are treasurer of the A corporation with power to sign commercial paper. Draw and sign a negotiable promissory note binding upon the corporation as maker.

Answer:

NEGOTIABLE INSTRUMENTS.

January 1, 1927.

Thirty days after date for value received the A corporation promises to pay to the order of X one thousand dollars with interest at the rate of 6% per annum.

THE A CORPORATION,
By: JOHN DOE,
Treasurer.

6. Jones ordered Cleary, a tailor, to make him a suit of clothes at a cost of $80. Cleary made the suit, but Jones refused to accept it and defended Cleary's action at law, pleading as a defense the statute of frauds. Was this a good defense?

Answer:

CONTRACTS. The question is whether this was a contract for the sale of goods, wares and merchandise for the price of $50 or more, which under the statute of frauds must be evidenced by some writing, or whether it is outside of the statute of frauds as being a contract for work and labor.

> "It has been said by the courts that there are few legal topics perplexed by a greater number of irreconcilable opinions than the question of law involved in this inquiry." 23 R. C. L., 1223.

The student may therefore exercise an election in answering this question.

7. A corporation is formed for the purpose of manufacturing, buying, selling and dealing in drugs, chemicals and similar products. The corporation, under authority of its board of directors, contracts to purchase the land and building occupied by it as a factory and store. G, a stockholder, sues in equity to restrain the corporation from completing the contract, claiming that, as the certificate of incorporation contained no provision authorizing the corporation to purchase real estate, the contract was *ultra vires*. Was G's claim correct?

Answer:

CORPORATIONS. No. The corporation organized for the purpose of manufacturing and selling has implied power to purchase real estate for its factory and store.

8. A borrowed $75 from B, giving to B as security for the loan a valuable Swiss watch. B placed the watch in his office safe. Burglars entered B's office, broke open the safe and took its contents including the watch. Is B liable for the loss of the watch?

Answer:

BAILMENTS. No. A contract of pledge being that of a compensated bailment, the pledgee's duties and liabilities are those of ordinary bailees for hire. He is only bound to use ordinary care in relation to the property pledged, and this he did by placing the watch in his office safe.

9. A makes and delivers to B a negotiable note payable ninety days after date, but fails to date the paper. B fills in a wrong date and negotiates it to C for value. What, as to C, is the correct date of maturity?

Answer:

NEGOTIABLE INSTRUMENTS. This question is faulty in that the statement that B "negotiates it to C for value" does not give enough information to show whether or not C became a holder in due course. There are other requirements than value, notably the requirement that the holder must have taken the note in good faith and without notice of any infirmity. If C did not take the note in good faith or had notice of the change in date, the correct date of maturity as to him would be the same as to B, that is, ninety days from the actual date the paper was made. Assuming, however, that C was a holder in due course, the correct date of maturity as to C would be ninety days after the date filled in by B. The person in possession of an undated negotiable instrument has prima facie authority to complete it by filling the blank. If in executing this prima facie authority he exceeds his actual authority from the maker by inserting the wrong date and negotiates it thereafter to a holder in due course, it is valid and effectual for all purposes in his hands and he may enforce it as if it had been filled strictly in accordance with the authority given.

10. Explain what is meant by the term "withholding agent" as used in the federal income-tax law.

Answer:

FEDERAL INCOME TAX. The term "withholding agent" means any trustee, corporation, partnership or individual required to deduct and withhold any tax under the provisions of section 221 or 237 of the revenue act of 1926.

11. The X corporation increases its authorized capitalization from $100,000 to $200,000. Can the directors offer the increased stock for subscription to the public generally?

Answer:

CORPORATIONS. No. Every stockholder has the right to suscribe at par for such a proportion of the newly authorized stock as his old holdings bear to the amount of stock then outstanding, and the directors can not by offering the new stock to the public generally deprive the stockholders of this right.

12. A firm of three members decided to dissolve and discontinue business. One of the members secretly obtained a lease of the property which the firm

had occupied for many years, the new lease to begin when the old one expired. This member obtained the lease prior to the dissolution, but it was known at the time that dissolution was contemplated. After dissolution the member sold the lease at a large profit. The other partners immediately sued to recover a share of the profit thus made. Could they succeed?

Answer:

PARTNERSHIP. This question is not without difficulty, but I should think that the partners could succeed in their action, the decision turning on the fact that the member obtained the lease prior to dissolution even though it was known at the time that dissolution was contemplated. Of course, had there been no dissolution of the firm, one member could not obtain a secret advantage with respect to property which was used by the partnership. A renewal of the lease obtained by one member would be for the benefit of the partnership. It would probably be argued, however, that as the firm was to be dissolved, the extension of the lease related to something in which the partnership was not interested, and therefore the member could deal in such a lease without doing anything in conflict with the partnership affairs. I should think this would be conclusively answered by the argument that since the partnership had not actually dissolved when the member obtained the lease, it was possible that the partners might wish to continue in the property, and by the further argument that the renewal of the lease of the partnership premises might be very important to the partnership even if dissolved, since without the lease the partnership goodwill would bring much less if sold upon dissolution. Incidentally, in the way the question is worded there is nothing to show that the old lease was not to expire before the date that the dissolution of the partnership was contemplated. In this case it is very clear that the partner could not for his own benefit secretly obtain a further lease covering part of the period when the partnership was still to be in existence.

13. A contract made, executed and delivered in Texas is the subject of a suit in Illinois. The laws of which state govern the validity and construction of the contract?

Answer:

CONTRACTS. The law of Texas, where the contract was entered into, governs. The parties are presumed to have had that law in mind when they contracted.

14. Is it necessary that a negotiable instrument contain the words "value received"?

Answer:

NEGOTIABLE INSTRUMENTS. No. The promise contained in a promissory note must be supported by consideration, but a promissory note under the negotiable instruments law imports consideration. It is therefore not necessary to have the instrument recite the words "value received."

15. Is a partnership required to make an income-tax return under the federal income-tax law? How are partnership profits taxed for income-tax purposes?

Answer:

FEDERAL INCOME TAX. A partnership is required to make a return for the information of the government, but it is not taxed as such. The individuals making up the partnership are taxed on their distributive shares whether distributed or not.

Students' Department

H. A. Finney, *Editor*

H. P. Baumann, *Associate Editor*

AMERICAN INSTITUTE EXAMINATIONS

(Note.—The fact that these answers appear in The Journal of Accountancy should not lead the reader to assume that they are the official answers of the board of examiners. They represent merely the personal opinions of the editors of the *Students' Department.*)

Examination in Auditing

November 18, 1926, 9 a. m. to 12.30 p. m.

The candidate must answer all the following questions:

No. 1 (10 points):

A client suspects, from a scrutiny of sales and gross-profit figures, that the purchase record is inflated. The client states that all cheques are signed by him personally, that he knows that inventories are correct and that the sales volume checks approximately with orders taken, and he is therefore at a loss to know how there can be any error. The client has called upon you to make what investigation you deem best. Describe the steps you would take in these circumstances and to what purpose.

Answer:

The first step in the investigation would be an examination of the facts upon which the client has based his suspicion that the purchase record is inflated. The auditor should not enter upon a detailed check of purchase records without a preliminary survey which will assure him that the client has correctly ascertained the facts and has drawn reasonably sound conclusions from them.

It may also be remarked, in passing, that the auditor should avoid an assumption of fraud until such a point is reached in his own investigation as will warrant it.

Assuming, then, that the auditor's preliminary examination indicates that the sales for the period and the inventories at the beginning and end of the period are correctly stated and that no unusual market conditions, increased transportation rates, changes in policy as to allowances of various kinds, or similar extraneous causes can be found which will account for the situation, he would next commence a detailed examination of the purchases shown for the period.

The fact that the client signs all cheques personally is no assurance, of course, that the disbursements made by means of such cheques were proper.

After ascertaining that the net purchases shown for the period represent the correct balance of net purchases shown by the ledger accounts for purchases, purchases returns and allowances, duty, freight and cartage, etc. (determined by proving footings and computations of balances), postings

from books of original entry would be verified to ascertain that no debits or credits applying to other accounts were posted to these accounts.

Footings of the books of original entry would then be verified to ascertain that there were no misstatements thereot due to errors or efforts to cover up misappropriations of cash.

At this point the auditor would be ready to verify the entries for purchases and the related items enumerated above. If probable sources of the overstatement of purchases had not suggested themselves to the auditor, he would have to decide whether to examine the items for the entire year or to select certain months for tests, and, in either case, whether to examine all items or merely those over a certain amount. Probably tests of several months as to items of a certain amount or over would be the most advisable procedure, until the auditor obtained some clue as to the source of overstatement, followed by detailed examination in the degree indicated as necessary by the preliminary findings.

Each entry would be verified by reference to supporting data proving the receipt of goods, the approval of quantities, prices, quality or grade, etc., by authorized persons. Particular attention would be given to possibilities of duplicate payments, unrecorded returns of purchased goods, and failure to make proper deductions for allowances of various kinds. Invoices would be examined to see that they were in the name of the company and did not cover any purchases of goods for the personal use of individuals which should have been charged to them. This procedure would be for the purpose of determining that all items included in purchases were properly so included.

The auditor would next investigate the methods of handling merchandise and the system of stock records, if any, maintained by the company to ascertain whether any merchandise might have been misappropriated, shipped without being billed, destroyed or lost in any other way.

At some point during the examination some indication would doubtless appear which would influence the auditor's subsequent course, and the exact procedure would be governed by such discoveries.

No. 2 (10 points):

(a) State how you would verify in the audit of a charitable institution the income comprising interest and dividends on securities, rents and contributions.

(b) State two means usually available for checking contributions, other than direct communication with the donors, and give your opinion as to which you consider the more satisfactory and why.

Answer:

(a) For the verification of income on securities in the case of a charitable institution, it would be necessary first to determine what securities were owned. The securities themselves would be verified by inspection or by certificates from the custodians thereof, supplemented by reference to the minutes of trustees' or directors' meetings, published acknowledgments of gifts, records of the purchase of securities for investment or of the exchange of old for new securities, and other probable sources of information as to securities which are or should be on hand. After determination of the income-producing securities owned, the income receivable thereon would be determined by reference to the terms of the instruments in the case of bonds, notes and preferred stocks, and by reference to published dividend records or by correspondence with the

companies in the case of common stocks. Actual receipt of the income would be verified by examination of the cash records. Appropriate verification would be required in the case of income receivable by the institution on securities not owned and in the case of securities the income from which might be payable to others. The treatment of bond premium and discount would also be examined to see whether or not provision was being made for amortization of such premium and discount.

Income from rents would be verified by examination of leases or other agreements with lessees or tenants, or, in case of renting agents, by reference to their reports. In either case, an effort would be made to account for all space available for renting, and to obtain satisfactory explanation of any space for which no rent was received. Underlying the verification would be the record of rent-producing property owned which would be ascertained from the various records of the institution, confirmed to the fullest extent possible by independent verification of the property owned. Verification would be necessary, as in the case of securities, if the institution either received the income from property not owned or owned property the income from which was payable to others.

Contributions would be verified by one or more of several methods, depending upon what records were maintained by the institution, such as:

(1) Examination of the stubs or duplicates of receipts where numbered receipts were issued for all contributions.
(2) Comparison of receipts with amounts pledged where pledges were made prior to actual contributions, with particular attention to pledges shown as unpaid.
(3) Comparison with published lists of contributions.
(4) Correspondence with donors.
(5) Reference to the minutes for record of large contributions.

(b) As stated in (a) above, contributions may be verified by examination of duplicate receipts or by reference to published lists of contributions without communicating with donors. It will depend wholly upon circumstances as to which method is more satisfactory, but, in general, the examination of published acknowledgment will be more satisfactory, particularly where such acknowledgment appears in an institution publication sent to all donors.

No. 3 (10 points):

You are called upon to audit the cash accounts, only, of a manufacturing company. What would your examination cover?

Answer:

If called upon to audit the cash accounts, only, of a manufacturing company, an auditor would need to ascertain to what extent he might accept the entries relating to cash transactions without further investigation of their completeness. An audit which merely proved or disproved that cash shown as received and disbursed, respectively, accounted for the change in the balance of cash between the beginning and end of the period, and, possibly, that all cash shown as disbursed was supported by properly signed cheques or receipts would ordinarily be of limited value, and would certainly be futile for the purpose of discovering irregularities resulting from failure to record cash receipts or from disbursements for improper or unauthorized purposes.

It would be to the auditor's interest as well as in accord with his obligations to the client to point out the limitations of an examination restricted to cash accounts only. If the client, however, indicated an understanding of these limitations or still desired to limit the scope of the audit after an explanation of the effect thereof, the auditor would proceed with his examination on the basis of his understanding with the client. The points covered would be as follows:

Receipts:

If the audit of cash accounts is to be detailed, all footings of the original records of cash receipts and all postings to the ledger accounts would be verified and, if possible, all receipts would be identified with specific deposits credited by the banks. Deposits made on the last day or two of the period would be examined in cases where more than one bank account is maintained, in order to detect deposits consisting of the company's own cheques on other banks which might not clear until the subsequent period and might be omitted from the record of cheques issued.

If the audit is to be only a general review of the cash records, sufficient tests would be made of the foregoing matters to satisfy the auditor as to the substantial integrity of the records. Comment should be made, however, that tests only were made and that the entries were not checked in detail.

Disbursements:

In the case of a detailed audit of the cash accounts, footings and postings would be verified completely and paid cheques returned by the bank would be compared with the entries therefor as to payees and amounts while endorsements and signatures would be scrutinized for indications of irregularity. All cheques would be examined to ascertain that they had actually gone through the bank. All cheque numbers would be accounted for and some attempt would be made to see that no unnumbered cheques or cheques taken from the back of a cheque book or from other than the current cheque books had been used and not properly accounted for.

Where a detailed audit is not desired, tests would be made of these matters in sufficient number to assure the auditor of the improbability of there being irregularities. Comment should be made, of course, as to the method followed. If the practice does not prevail of depositing receipts intact and making all disbursements by cheque the auditor's procedure would have to be altered to meet such a condition. Cash disbursements not represented by paid cheques would be examined with a great deal of care and any not represented by satisfactory vouchers therefor would be the subject of special inquiry.

No. 4 (10 points):

A company having an issue of debenture bonds of $500,000, maturing in 20 years from date of issue, is carrying the unexpired bond discount as a deferred charge, the bonds having been issued at 90. The bonds contain a sinking-fund provision requiring the retirement of one-twentieth of the issue annually, the necessary bonds to be called at 105 unless secured through purchase at a more advantageous price. At the beginning of the sixth year, the directors availed themselves of an offer by purchasing fifty $1,000 bonds at 85. How should the bonds purchased and the 15 per cent. discount thereon appear in the accounts?

Answer:

The question states that the company's bonds contain a sinking-fund provision requiring the retirement of one twentieth of the issue annually. This appears to be a conflict in terms. A sinking-fund is strictly defined as a fund accumulating at compound interest to retire a definite liability at its maturity. Within this strict meaning the purchase of bonds could be accomplished only by turning them over to the sinking-fund trustee, who would hold them alive in the fund and continue to collect the interest on them. The company would still regard the bonds as outstanding.

But the question states that one twentieth of the issue is to be retired annually. This would mean that the liability for the retired bonds would disappear from the company's books and from its balance-sheet.

The question is an important one because it affects the amortization of the discount. If a sinking fund is operated in accordance with its strict definition, the purchased bonds will appear as an asset in the fund, and also as a liability, and the discount should be amortized in equal amounts annually (assuming that absolute accuracy did not require the application of a scientifically correct amortization by an actuarial effective-rate method).

It is believed that the question means that the bonds are actually retired. While emphasis has been given above to the strict definition of a sinking fund, it is recognized that the term is often used to denote what would be more accurately defined as a retirement fund. Assuming, then, that the $25,000 of bonds purchased each year were to be canceled and not held alive in a sinking fund, the discount should be amortized by some method which would take into consideration the annually diminishing amounts of bonds outstanding. By using such a method it would be unnecessary to make any adjustment of the bond discount at the time of retiring the required one-twentieth of the issue each year. This would mean that if during the sixth year only $25,000 of bonds had been purchased for retirement at 85, it would have been necessary to credit surplus with 15 per cent. of $25,000, or $3,750.

The fact that the bonds were purchased at the beginning of the year is ignored because it is not known whether provisions for amortization of the bond discount have been based on retirement of the annual quota of $25,000 at the beginning or at the end of the year.

But the company also purchased $25,000 of bonds which it was not obligated to retire until a year later, the unamortized discount on which would have to be charged to surplus either directly or as an offset to part of the 15 per cent. discount on the bonds purchased.

A question now arises as to whether the bonds purchased one year in advance are to be canceled at that date or held in the treasury for a year and presented for cancellation then. If the trustee will agree that a purchase of $50,000 during the sixth year meets the requirements for the sixth and seventh years, the entries should be:

(1)

Bonds payable	$50,000	
Cash		$42,500
Surplus		7,500
To record the purchase and retirement of $50,000 par value of bonds at 85.		

(2)

Surplus....................................	——	
Bond discount............................		——
To charge to surplus the unamortized discount on $25,000 of bonds retired one year in advance of the required date of retirement.		

If the trustee will not agree to accept the purchase in the sixth year as meeting the seventh year's requirements, the company would probably hold $25,000 of the bonds as treasury bonds for presentation the next year. That would affect the foregoing entry only to the extent of dividing the charge of $50,000, one half of the amount being charged to bonds payable and the other half to treasury bonds. The debits and credits to discount and surplus accounts should still be made as in the foregoing entries because the bonds would be virtually dead; no interest would be paid on them, and hence no charge should be made during the year for either interest or discount amortization. That would necessitate relieving the accounts of the discount at the date of acquisition.

No. 5 (10 points):

In the course of your audit of the X Y Z Co., you find in your investigation of its operations that its costs are based upon standard or predetermined costs, the cost system being controlled in the general accounts. All calculations are based upon operating at 75 per cent. of capacity. However, during the year, operations were from 90 per cent. to 95 per cent. of capacity, with the result that factory overhead was over-absorbed to the extent of $75,000, which remains as a credit balance in the burden-control account. The company officers are not quite certain what should be done with this credit balance and ask your opinion. How would you proceed to find a solution of this problem, and what would your recommendations be? Explain, without using figures, what should be done with the credit balance.

Answer:

Inasmuch as the X Y Z Co. has operated at a larger percentage of capacity than anticipated, the actual cost of the product has been overstated due to the use of standard or predetermined costs based upon the distribution of factory overhead over a smaller volume than was actually produced. To the extent that sales during the period were of goods manufactured during the period, therefore, the cost of goods sold was overstated and profits for the period correspondingly understated. The inventory at the end of the period was overstated in so far as it included goods, manufactured during the period, priced at the standard or predetermined cost.

In order to adjust the matter, the respective amounts of goods manufactured which were sold or remained in inventory should be determined and proportionate parts of the $75,000 credit balance in the burden-control account credited to profit-and-loss account and inventory account.

It might also be desirable to adjust the cost records for the year so that each job, product or process, would be stated at actual cost. This might be possible but in many cases would not be practicable.

No. 6 (10 points):

Give seven indications of a healthy financial condition which might appear on the balance-sheet and profit-and-loss statement of a manufacturing concern.

Answer:

Seven indications of a healthy financial condition which might appear on the balance-sheet and profit-and-loss statement of a manufacturing concern are:

1. Adequate working capital.
2. Large amount of cash and marketable securities in proportion to other current assets and to current liabilities.
3. Small amount of obligations involving fixed charges.
4. Large surplus account.
5. Adequate reserves for depreciation, depletion, obsolescence, amortization, etc.
6. Absence of excessive amount of goodwill, patents, or other intangibles.
7. Small amount of inventories of material and merchandise in relation to amount of goods sold.

Indications of a healthy financial condition would not usually be sought in a profit-and-loss statement alone although, of course, in that statement will be found indications as to whether the business is being conducted in such a manner as to improve the financial condition or vice versa. In conjunction with the balance-sheet the profit-and-loss statement would be of value in determining the relation of inventories and accounts receivable to cost of goods sold and sales, respectively; the relation of investment in plant to sales; the amount of interest paid, and other matters of collateral interest in an examination of financial condition.

No. 7 (10 points):

In making a balance-sheet audit of a corporation you notice the following items:

(a) Unissued common stock carried as treasury stock.

(b) Dividend cheques drawn regularly for this unissued stock and charged to "dividends," the cheques being redeposited and credited to treasury-stock account.

(c) Corporation carried life insurance on its president, policy payable to the preferred stockholders.

The treasurer instructs the auditor to make any entries on the books which are deemed necessary. What adjustments, if any, would you make on the books and what special comments should the auditor's report contain?

Answer:

The following adjustments should be made on the books:

(1) An entry crediting surplus and debiting treasury stock for the amount of dividends on treasury stock which has been credited to the treasury-stock account.

(2) An entry crediting treasury stock and debiting unissued stock for the unissued stock carried as treasury stock.

The matter of necessary adjustments with respect to the life-insurance policy payable to preferred stockholders carried by the corporation depends upon what entries have been made. The premiums should, of course, have been charged to expense and not to an asset account. Moreover, the setting up as an asset of the cash surrender value of the policy at the time such value becomes effective would appear to be of questionable propriety in this case. Since the corporation itself is not the beneficiary and since it is not known that the cash value would belong to the corporation in case the policy should be

surrendered, there is no basis for treating the cash value as an asset of the corporation.

Comment in the auditor's report would seem to be required in explanation of the adjustment of surplus for dividends previously "paid" on the unissued stock, and also in regard to the payment of premiums on the life-insurance policy payable to preferred stockholders.

No. 8 (10 points):

You have been engaged to make an audit of the books of a corporation for the purpose of submitting certified statements to bankers. You find during the course of your work that the corporation owns all the capital stock of a subsidiary company, but you are refused access to the books of the subsidiary. What position would you take if the officers insisted upon an unqualified statement?

Answer:

If the officers insisted upon an unqualified statement, the auditor could take no position other than that of declining to furnish a statement. The inclusion of any asset in the auditor's statement without qualification in regard thereto would imply that such an asset was, in the auditor's opinion, of the value stated. Since the value of the investment in the subsidiary could be determined only by examination of the subsidiary's books, the least that the auditor could do in the absence of such examination would be to qualify the statement in that respect. The fact that he was refused access to the books, however, would seem to indicate that they might contain information unfavorable to the corporation, and should lead the auditor to refuse to submit any statement without an examination of the books of the subsidiary or a comment that access thereto had been refused.

No. 9 (10 points):

Upon examining the accounts of a manufacturer of musical instruments, who sells to the retail trade on an instalment basis, you find that repossessed instruments (i. e., instruments sold and replevined due to failure of customer to pay instalments due) are included in the inventory at original cost plus cost of reconditioning. Give your reasons for agreeing or disagreeing with this state of the accounts.

Answer:

The inclusion of repossessed instruments in the inventory at original cost plus cost of reconditioning is contrary to generally accepted accounting principles in that it states the inventory at an amount in excess of that determined on the basis of either cost, market, or any other recognized basis of inventory valuation. The instruments should properly be valued at the time of repossession at original cost minus any depreciation due to wear or damage. Subsequent costs of reconditioning these instruments would be proper additions to such adjusted cost in arriving at their inventory value.

When original cost plus reconditioning costs is used as the valuation for inventory purposes, the result is that expenses or costs applicable to the period prior to the inventory date, the period in which the original sale occurred, are not charged against the income of that period but are carried forward to be charged against income of the period in which the instrument is resold.

No. 10 (10 points):

During the course of an audit of the books of a company manufacturing and installing large units of electrical machinery, you find an account receivable of

$100,000 due on contract No. 100. Upon a further examination of this account and contract, you find the following conditions:

The total amount of the contract is $200,000 and by reason of certain concessions the customer agreed to pay one-half upon signing the contract and one-half upon completion of the installation. You find that at December 31, 1925, the contract has been signed, $100,000 has been received, but work on the contract has not been commenced. The following entries appear on the books:

Accounts receivable....................	$200,000	
To sales............................		$200,000
Cost of sales (estimated)................	120,000	
To reserve for construction costs.......		120,000
Cash..................................	100,000	
To accounts receivable................		100,000

The officers of the company advance the explanation that, inasmuch as conservative estimates show that the contract will net a profit of $80,000, and having received $100,000 in cash, they are correct in taking up all the profit. What would you do under these conditions?

Answer:

It was an error for the company to take up any portion of the estimated amount of profit on the contract prior to commencement of the work. After commencement of the work it would be proper to take up only that proportion of the total estimated amount of profit which the cost of completed work bore to the total estimated cost of the completed contract.

Until all or part of the services are performed under the contract, no portion of the profit thereon is earned. Moreover, until the work is commenced, the company has no valid claim against the customer and would have to refund the $100,000 if for any reason the company's part of the contract should not be performed.

The auditor should, under these conditions, suggest that adjustments be made in the accounts as follows:

December 31, 1925

Profit and loss..............................	$ 80,000	
Reserve for construction costs.................	120,000	
Accounts receivable........................		$100,000
Advance collections on contracts.............		100,000
To correct error in recording advance collection from ....and taking up the estimated amount of profit to be earned on contract No.—— not yet commenced.		

If the company failed to comply with the suggestion, the auditor should nevertheless make the adjustments in preparing his own statements with suitable comment that the company's books had not been adjusted correspondingly.

CONSOLIDATED BALANCE-SHEET

The following problem appeared in the Illinois C. P. A. examination given in May, 1925:

The following facts are to be considered in preparing a consolidated balance-sheet:

Items Dec. 31, 1923, before affiliation	Co. A	Co. B	Co. C
Goodwill..............................	$......	$20,000	$......
Capital stock..........................	900,000	400,000	300,000
Surplus..............................	100,000	40,000	100,000

1. On December 31, 1923, company A acquired all of the capital stock of company B for $400,000 and 80 per cent. of the capital stock of company C for $360,000; while company B on the same day acquired 10 per cent. of the capital stock of company C for $45,000.
2. During the year ended December 31, 1924, the operations resulted as follows:
   Company A, profit $30,000 exclusive of dividend from company B.
   Company B, profit $40,000.
   Company C, loss $10,000.
3. Company B declared and paid a dividend of 5 per cent. during 1924.
4. Company A declared and paid a dividend of 5 per cent. during 1924.

From the foregoing data prepare as much as possible of a consolidated balance-sheet as of December 31, 1924, setting forth clearly the investments, goodwill, capital stock, surplus, eliminations and minority interests, if any, assuming that none of the three companies enters on its books its share of earnings of an allied company except when received as dividends.

Solution:

In the solution of this problem, it is necessary to set up the balance-sheets of the various companies at December 31, 1924.

These balance-sheets are obtained by means of the working papers on pages 387–388.

Inasmuch as company A and company B have not taken up their shares of subsidiary profits and losses and have, instead, credited to surplus the amount of dividends received, adjustments must be made in the working papers for such profits and losses. The profits of company B to be taken up by company A must first be adjusted for the amount of company B's proportion of company C's loss for the year ended December 31, 1924. The necessary adjustments are as follows:

(1) and (2) To adjust surplus and investment accounts of company A and company B for their respective shares of company C's loss for the year ended December 31, 1924.

(3) To adjust surplus and investment accounts of company A for company A's share of company B's profits for the year ended December 31, 1924.

(4) To adjust surplus and investment accounts of company A for dividend received from company B.

(See pages 389 and 390.)

COMPANY A AND SUBSIDIARIES, COMPANY B AND COMPANY C

Consolidated balance-sheet December 31, 1924

Assets		
Sundry assets		$1,030,000.00
Goodwill		25,000.00
		$1,055,000.00
Liabilities and Net Worth		
Liabilities		$
Minority interest in company C (10%)		39,000.00
Net worth:		
Capital stock	$900,000.00	
Surplus	116,000.00	1,016,000.00
		$1,055,000.00

COMPANY A, COMPANY B AND COMPANY C

Working papers for the year ending December 31, 1924

	Balance-sheet December 31, 1923, before affiliation	Adjustments Dr.	Adjustments Cr.	Balance-sheet December 31, 1924	Explanation of adjustments
Company A:					
Assets					
Sundry assets (net)............	$1,000,000.00	(2) $30,000.00	(1) $760,000.00		(1) To record investment in companies B and C.
		(3) 20,000.00	(4) 45,000.00	$245,000.00	(2) To record profits for year ended December 31, 1924,
Investment in company B......		(1) 400,000.00		400,000.00	exclusive of dividend from company B.
Investment in company C......		(1) 360,000.00		360,000.00	(3) To record dividend received from company B.
					(4) To record dividend paid.
	$1,000,000.00			$1,005,000.00	
Net Worth					
Capital stock.................	$900,000.00			$900,000.00	
Surplus......................	100,000.00	(4) 45,000.00	(2) 30,000.00		
			(3) 20,000.00	105,000.00	
	$1,000,000.00	$855,000.00	$855,000.00	$1,005,000.00	
Company B:					
Assets					
Sundry assets (net)............	$420,000.00	(2) $40,000.00	(1) $45,000.00	$395,000.00	(1) To record investment in company C.
			(3) 20,000.00		(2) To record profits for year ended December 31, 1924.
Goodwill.....................	20,000.00			20,000.00	(3) To record dividend paid.
Investment in company C......		(1) 45,000.00		45,000.00	
	$440,000.00			$460,000.00	
Net Worth					
Capital stock.................	$400,000.00			$400,000.00	
Surplus......................	40,000.00	(3) 20,000.00	(2) 40,000.00	60,000.00	
	$440,000.00	$105,000.00	$105,000.00	$460,000.00	

COMPANY A, COMPANY B AND COMPANY C
Working papers for the year ending December 31, 1924 (*continued*)

Company C:	Balance-sheet December 31, 1923, before affiliation	Adjustments Dr.	Adjustments Cr.	Balance-sheet December 31, 1924	Explanation of adjustments
Assets					
Sundry assets (net)	$400,000.00		(1) $10,000.00	$390,000.00	(1) To record loss for year ended December 31, 1924.
Net Worth					
Capital stock	$300,000.00			$300,000.00	
Surplus	100,000.00	(1) $10,000.00		90,000.00	
	$400,000.00	$10,000.00	$10,000.00	$390,000.00	

COMPANY A AND SUBSIDIARIES, COMPANY B AND COMPANY C

Consolidated balance-sheet, working papers December 31, 1924

Assets	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Consolidated balance-sheet
Sundry assets (net)	$245,000.00	$395,000.00	$390,000.00				$1,030,000.00
Goodwill		20,000.00					20,000.00 G
Investments:							
Company A's investment in company B	400,000.00						
Add: Company A's share of company B's profits				(3) $39,000.00			
Deduct: Adjustment for dividend received from company B					(4) $20,000.00		
Eliminate present book value:							
Capital stock—100% of $400,000						(A) $400,000.00	
Surplus—100% of $59,000						(A) 59,000.00	
Deduction from goodwill							40,000.00*G
Company A's investment in company C	360,000.00						
Deduct: Company A's share of company C's loss					(2) 8,000.00		
Eliminate present book value:							
Capital stock—80% of $300,000						(B) 240,000.00	
Surplus—80% of $90,000						(B) 72,000.00	
Goodwill							40,000.00 G
Company B's investment in company C		45,000.00					
Deduct: Company B's share of company C's loss					(1) 1,000.00		
Eliminate present book value:							
Capital stock—10% of $300,000						(C) 30,000.00	
Surplus—10% of $90,000						(C) 9,000.00	
Goodwill							5,000.00 G
	$1,005,000.00	$460,000.00	$390,000.00	$39,000.00	$29,000.00	$810,000.00	$1,055,000.00

* Deduction from goodwill.

COMPANY A AND SUBSIDIARIES, COMPANY B AND COMPANY C

Consolidated balance-sheet, working papers, December 31, 1924 (*continued*)

	Company A	Company B	Company C	Adjustments Dr.	Adjustments Cr.	Eliminations	Consolidated balance-sheet
Totals of adjustments brought forward				$39,000.00	$29,000.00		
Liabilities and Net Worth							
Capital stock:							
Company A	$900,000.00						$900,000.00
Company B		$400,000.00					
Eliminate company A's 100%						(A) $400,000.00	
Company C			$300,000.00				
Eliminate company A's 80%						(B) 240,000.00	
Eliminate company B's 10%						(C) 30,000.00	
Minority interest 10%							30,000.00 M
Surplus:							
Company A	105,000.00						
Adjustment for dividends from company B				(4) 20,000.00			
Share of company B's profit 100%					(3) 39,000.00		
Share of company C's loss 80%				(2) 8,000.00			
Adjusted surplus							116,000.00 S
Company B		60,000.00					
Share of company C's loss 10%				(1) 1,000.00			
Adjusted surplus=$59,000							
Eliminate company A's 100%						(A) 59,000.00	
Company C			90,000.00				
Eliminate company A's 80%						(B) 72,000.00	
Eliminate company B's 10%						(C) 9,000.00	
Minority interest 10%							9,000.00 M
	$1,005,000.00	$460,000.00	$390,000.00	$68,000.00	$68,000.00	$810,000.00	$1,055,000.00

Book Reviews

ACCOUNTING PROCEDURES FOR PUBLIC UTILITIES, by WARREN G. BAILEY and D. E. KNOWLES. *A. W. Shaw Co.*, New York. 471 pages.

On the title page of *Accounting Procedures for Public Utilities*, the following appears after the title: "With special reference to electric-light, gas, water, and electric-railway utility companies."

It would have been better had the title itself been modified, as there is practically nothing in the book, outside of generalizations, that applies to the accounting for utilities other than those mentioned above.

Perhaps the best way to indicate the scope intended to be covered by the authors is to list the chapter headings which, in most instances, are self-explanatory. They are as follows, the numbers in parentheses representing the number of pages devoted to each chapter:

I, Introduction (29); II, Place of accounting in public utilities (8); III, Uniform accounting for utility companies (19); IV, General accounting books (18); V, Expense accounting (14); VI, Timekeeping and payroll methods (18); VII, Distribution of labor charges (9); VIII, Departmental responsibilities in accounting for materials (6); IX, Accounting for materials and supplies (22); X, Plant accounting (15); XI, Current liabilities (20); XII, Revenues from utility services (12); XIII, Revenue accounting for electric, gas and water services (22); XIV, Accounting for merchandise sales (19); XV, Accounting for revenue of electric railways (20); XVI, Customers' accounting: Multiple account ledger sheet system (15); XVII, Customers' accounting: Miscellaneous bookkeeping operations (19); XVIII, Customers' accounting: The bill-stub plan of bookkeeping (16); XIX, Customers' accounting: The register and individual account systems (13); XX, Accounting for customers' payments and petty cash (19); XXI, Accounting for refunds and adjustments with customers (13); XXII, Auditing procedure (22); XXIII, Budget procedure (27); XXIV, Interpretation of financial and operating statements (19); XXV, Public-utility construction and extensions (14); XXVI, Accounting for capital stock and dividends (17); XXVII, Accounting for capital-stock sales (12).

There is also an index of nine pages and a list of forms, thirty-nine in number.

The introductory chapter deals with the development and growth of public utilities and the powers of public-utility commissions, and the chapter on plant accounting contains some data on the subject of the rate base. The chapter on uniform accounting is based upon the uniform classifications of accounts for water, gas and electrical utilities prepared by the National Association of Railway and Utilities Commissioners. These classifications, it is stated, have been adopted completely, or in substance, by the commissions of twenty-five states.

After reading the book, one is apt to have what may be termed a reaction complex, particularly if one has been initiated previously in the intricacies of utility accounting and is cognizant of the necessity for accurate accounting information in preparation for rate proceedings and for clearly expressed thoughts in relation to the problems involved.

Parts of the book evidence careful research, other parts are obviously based upon misinformation, or incomplete information, still others appear to have been carelessly edited or proofread, and here and there the authors have wandered afield into the realm of administrative functions with some elementary advice thrown in for good measure.

In other words, the value of the book may well be summarized by resorting to metaphor and borrowing the title of an old song which runs as follows:

Just a little tenor
Just a little baritone
Just a little base

EDWARD H. MOERAN.

TESTING BEFORE INVESTING, by EDMOND E. LINCOLN. *A. W. Shaw Co.*, New York. 96 pages+xii.

A lady recently complained bitterly that the authorities of a hospital in which her husband was a patient allowed him nothing but "sippy" food. The expression was new to me and is not to be found in the new *Century Dictionary*, but, like many new words, it is expressive and at once suggests food which can be easily digested, even if its food value be somewhat low.

Such a description can properly be applied to the book called *Testing Before Investing:* it is elementary, easily absorbed and easily digested. If Joe Jinks would but study it he would not invest in unseen reported oil wells in Texas and Mr. Gump would not have lost so much of Uncle Bim's money.

The book is addressed to a portion of the community which is of importance and of growing importance, namely, "The new owners of industry, who save and invest while they work." It is full to the brim of good advice and is free from controversial matter; facts and advice are plainly stated and are addressed chiefly to that enormous class "The salaried man" who is urged repeatedly to "*get competent advice*".

After describing the various types of investors, we are told "how to start" and "how not to start". Mention is then made of the various sign posts by the way which may be consulted, and then follows a discussion which might be called "Bonds versus stocks."

A chapter is devoted to the various general classes of securities such as public utilities, rails, industrials, foreign bonds, and real-estate bonds, and in each case a brief form of analysis is given.

After a consideration of business cycles, we are told how to buy bonds and stocks and are furnished with a glossary of investment terms.

An accountant of experience, if a Frenchman, might dismiss the book with "Ça va sans dire," but he should remember that he has benefited by the experience of many foolish clients of the "Joe" and "Gump" class.

To the young man, to him who is not brought into touch with investments and to whom the language of Wall street is an unknown tongue, the book forms a safe guide to start him safely on a road where, after all that is said and written and done, experience is the only guide of value. If only we could or would or had followed Mr. Lincoln's advice, many of us would today have a larger bank account and a less costly crop of experience.

WALTER MUCKLOW.

FINANCIAL MANAGEMENT OF FARMERS' ELEVATORS, by GERALD M. FRANCIS. *A. W. Shaw Co.*, New York. 109 pages.

The title page of *Financial Management of Farmers' Elevators* states that this is a study in the principles of corporate finance as applied to grain marketing companies, and the foreword informs the reader that the book received the second prize offered in 1926 by the Chicago Trust Company for monographs in the field of business development and the modern trust company.

The author deserves commendation for the care exercised in the preparation of his work. Throughout the book the text is amplified and illustrated by forms and tables, and footnotes make reference to the author's sources of information. At the end of the volume is an index and a bibliography showing the books, pamphlets and periodicals containing material relating to coöperative grain marketing made use of in the preparation of the thesis.

The first two chapters are introductory and historical, covering such subjects as the early causes of coöperation, the origin and effect of the "maintenance clause," price stabilization through control of supply, the legal recognition of farmers' needs, the competitive strength of farmers' elevators and their importance to grain pools. Herein is one conclusion which should challenge the serious attention of coöperative executives; i. e., while the establishment of competition in local buying has been a profitable achievement for the farmers, this has been accomplished in spite of the fact that there is an abundance of opportunity for farmers to develop greater efficiency and economy in the business of handling grain.

The succeeding chapters are devoted to a discussion of financial operations. Due to the aversion of farmers to the assumption of the burdens of complex business and the expense incident to the maintenance of adequate records, Mr. Francis finds a lack of dependable figures affording a basis for the solution of the problems of farmers' companies.

The author does not maintain that the data presented as the result of his study are sufficiently broad or representative to justify final conclusion on all points of management discussed, yet he has made good use of the materials at hand and has made an important contribution to a more or less neglected subject. Any coöperative elevator which must depend upon local bankers for credit will undoubtedly find that the amount of credit obtainable and the interest rates demanded will depend upon the factors set forth in the author's analysis.

The use of these studies would make it easier for the intelligent manager to determine and to maintain his institution's claim to sound credit standing, and would enable him to prepare against possible depression in the grain-elevator business.

Chapter eight contains an analysis of the liability of farmers' coöperative associations for federal income taxes. This analysis points out the conditions precedent to exemption and indicates the changes that may be of assistance to those companies operating close to the border line.

The author points out a condition that has long been known to accountants. A survey of the records of coöperatives indicates that the companies too frequently rely upon inadequate audits both internal and external. The farmer's aversion to bookkeeping has prevented a full appreciation of the

benefits derived from the employment of skilled accounting and financial counsel.

It is clearly demonstrated that farmers' companies must realize that the precautions necessary in ordinary business management are equally essential to the success ot coöperatives. Coöperatives are subject to the same economic laws as govern other enterprises. The form of coöperative organization employed and its relation to a terminal association, while important problems, are in fact secondary to the internal financial management of the individual companies.

This book should be on the shelf of every accountant who numbers farmers' companies among his clients.

ELLIS LEMASTER.

DEPRECIATION, RESERVES AND RESERVE FUNDS, by LAWRENCE R. DICKSEE. *Gee & Co.*, London. 78 pages.

Depreciation, Reserves and Reserve Funds is the fifth edition of volume XXVI of The Accountants' Library, a brief textbook for English students on the subjects indicated in the title. To an American reader its most striking characteristic is the difference in nomenclature from ours with respect to reserves and reserve funds, a feature sure to cause confusion in the minds of American students of accountancy. For example, Professor Dicksee places both reserves and reserve funds on the liability side of the balance-sheet, whereas American teaching prescribes that a reserve is a liability but a reserve fund is an asset. It only adds to the confusion (of the American student) to be told (on page 57) that a sinking fund is "very widely used to cover any systematic accumulation of moneys for the repayment of liabilities becoming due at definite future dates" and then to read further (on page 61), ". . . the account that would ordinarily be called 'reserve for depreciation account' might be styled 'sinking fund' and so stated on the liabilities' side of the balance-sheet. . . ."

It is, of course, merely a matter of defining terms. Translated into American usage what Professor Dicksee calls a "reserve" is our operating reserve, i. e. a reserve created by a charge in current operating expenses; his reserve fund is our reserve from profits or surplus. Our sinking fund records actual cash or securities set aside for specific purposes; Professor Dicksee calls it an investment account. Our sinking-fund reserve is his sinking-fund account.

And yet we pride ourselves (sometimes) on using a "common language"! But one would think the editors of the Library would give some attention to such differences in usage before seeking an American market.

W. H. LAWTON.

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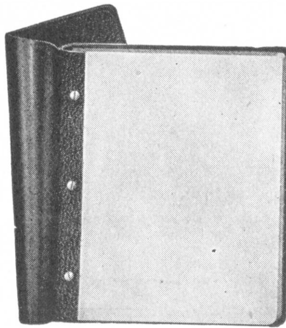

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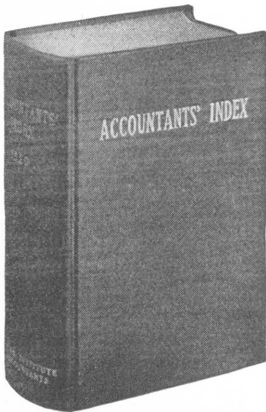

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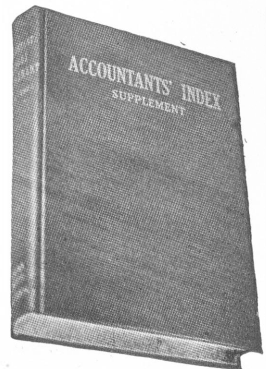

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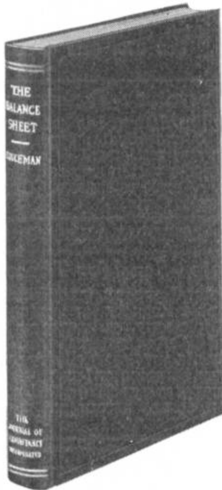

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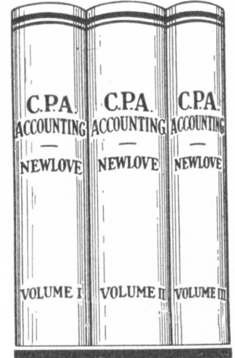

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