SINGLE COPY 35 CENTS PER ANNUM $4.00

# *The* JOURNAL *of* ACCOUNTANCY

VOLUME XLIII JUNE, 1927 NUMBER 6

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Issued Monthly by

THE JOURNAL OF ACCOUNTANCY, Incorporated, *Publishers*

*Publication Office,* 10 Ferry Street, Concord, N. H.

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Entered as second-class matter at the Post Office at Concord, New Hampshire, under Act of March 3, 1879

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 43 | JUNE, 1927 | No. 6

# The Dawes Plan in Operation*

BY JOSEPH E. STERRETT

The Dawes Plan has been in operation for less than three years, but even this brief space of time has been sufficient to create a sort of legend which obscures in many minds the deeper meaning and purpose of the Plan. In considering what the fruits of the Plan have been and some of its possible implications for the future, it is desirable to reëxamine briefly the historical setting of the Plan and also to restate its purposes and some of the means by which it was hoped those purposes might be attained.

From the signing of the Peace Treaty of Versailles in June of 1919, reparations became the central economic problem in European affairs. Nothing could be settled until the reparation problem was solved and, instead of being left for settlement by an independent body who could view it as a business problem, it became the football of both national and international politics. Conference followed conference and the situation grew steadily worse. The Reparation Commission, representing the Allied Governments, made demands upon Germany for reparation payments, and in the earlier days succeeded in collecting substantial amounts. These demands, however, were not based upon a scientific study of Germany's ability to pay and had little regard to their effect upon the German economy. Not only in Germany but in the Allied countries as well, reparations were at least a contributing factor in the dislocation of the currencies.

In consequence of currency conditions, especially those in Germany, business had no assured basis and every transaction which involved the factor of time had in it necessarily a large element of speculation. At the end, Germany was prostrated, its currency became practically worthless, one gold mark being equal to a trillion paper marks. Reparations were not being

*An address delivered at the annual meeting of the Chamber of Commerce of the United States of America, Washington, D. C., May 3, 1927.

paid, and what looked like an interminable deadlock was strangling Germany and doing vast injury to the Allied nations. An effort had been made to collect reparations by force but the principal result was a crop of deep bitterness.

By one of the greatest of modern miracles, Germany, in the midst of this situation, stabilized its currency late in the year 1923. The rentenmark, as the new currency was called, had a value equivalent to the old mark. It had no gold backing, but merely a mortgage upon the land, and to some extent upon personal property; yet in spite of this, the German people had a measure of confidence in this new currency sufficient to enable its equilibrium to be maintained. Obviously, however, this equilibrium could not have been continued for long without some kind of a settlement of the reparation problem and without the help of a foreign loan. Demands by the Allies for payments on account of reparation might, and probably would, have placed a burden upon the German budget which would have again started the dreary round of inflation.

It was at this point in December, 1923, that the Reparation Commission appointed two Committees, the first of which, soon known as the Dawes Committee, was "entrusted with considering the means of balancing the budget and the measures to be taken to stabilize the currency" of Germany. The other Committee was to "consider the means of estimating the amount of exported capital and to bring it back into Germany." The work of this second Committee was done with careful thoroughness and its report is a valuable one. It, however, does not form part of the subject which we are now discussing and is therefore merely mentioned in passing.

The First Committee of Experts, as it is technically known, was presided over by General Dawes, and most of us remember the eager interest with which its report was received in April, 1924. The spirit of the report is indicated by its Chairman in his letter transmitting the report to the Reparation Commission. In that letter he said:

> "Deeply impressed by a sense of its responsibility to your Commission and to the universal conscience, the Committee bases its plan upon those principles of justice, fairness and mutual interest, in the supremacy of which not only the creditors of Germany and Germany herself, but the world, has a vital and enduring concern.
>
> "With these principles fixed and accepted in that common good faith which is the foundation of all business, and the best safeguard for universal peace, the recommendations of the Committee must be considered not as

inflicting penalties, but as suggesting means for assisting the economic recovery of all the European peoples and the entry upon a new period of happiness and prosperity unmenaced by war."

As evidencing its attitude toward the problem which had been submitted to it, the Committee, in its report, said:

"We have approached our task as business men anxious to obtain effective results. We have been concerned with the technical, and not the political, aspects of the problem presented to us. We have recognized indeed that political considerations necessarily set certain limits within which a solution must be found if it is to have any chance of acceptance. To this extent, and to this extent only, we have borne them in mind. . . .

"As regards past history, it has not seemed necessary to establish the causes, nor the responsibility for those causes, which have operated to produce the present state of German finances and currency, except in so far as a recognition of their character is required for the prescription of remedies.

"Finally, convinced as we are, that it is hopeless to build any constructive scheme unless this finds its own guarantee in the fact that it is to the interest of all the parties to carry it out in good faith, we put forward our plan relying upon this interest."

It will be observed that the First Committee was charged with the duty of finding means of stabilizing the German currency and balancing the German budget. These objects had to be attained in the light of Germany's reparation obligations. Indeed, as the Committee said, "The dominating feature of the German budget is Germany's obligation to the Allies under the Treaty of Versailles." Consequently, any plan under which the German budget could be balanced and the stability of the currency assured, had to specify a definite basis for determining the reparation burden upon the German economy. Upon this point the Committee was emphatic; "We desire to make it quite clear that the sums denoted above in our examination of the successive years, comprise all amounts for which Germany may be liable to the Allied and Associated powers for the costs arising out of the war including reparation, restitution, all costs of all armies of occupation," and all other similar charges. This is the so called "all-inclusive" feature of the annuities provided under the Plan. By it the maximum annual burden upon Germany is definitely limited. It is one of the principal safeguards of the German budget and of the German currency.

The annuities started at 1,000 million gold marks for the first year, which began on September 1, 1924, and will increase each year until the fifth year, beginning on September 1, 1928, when the maximum, or standard, annuity of 2,500 million gold marks is to be reached. All payments made by Germany on account of these annuities are paid in gold marks, or their equivalent in

German currency, into the Reichsbank to the credit of the Agent General for Reparation Payments; in the language of the Experts' Report, "This payment is the definitive act of the German Government in meeting its financial obligations under the Plan."

The funds necessary to meet these annuities are derived in part from the interest and the sinking fund on the eleven milliards of Germany railway bonds and from the interest and the sinking fund upon the five milliards of industrial debentures. These obligations are secured by a mortgage upon the German railways and by a somewhat similar lien upon the industrial establishments of the country. Another substantial part of the annuity is derived from the yield of the transport tax levied upon the transportation of goods and passengers in Germany. The remainder of each annuity is a direct charge upon the German budget and is secured by the so-called controlled revenues, that is, the yield from the taxes on customs, alcohol, tobacco, beer and sugar. During the present or third annuity year, this direct charge upon the budget represents one-fifth of the total annuity. It increases, however, until in the fifth or standard year it will constitute one-half of the annuity.

It is the aim of the Plan to place upon Germany the responsibility for the raising of these funds and the paying of them into the Reichsbank. There is only a minimum amount of foreign control. The Reichsbank has seven foreign members out of fourteen upon its general Council; one of the foreign members acts as a Commissioner and is in control of the note issue. There are at present four foreign out of the fourteen members of the German Railway Board and a foreign Commissioner who has broad powers in the event of a default; and there is a foreign trustee for the railway bonds. There are seven foreign out of the fifteen members of the Board of the Bank for German Industrial Debentures; and there is also a foreign Commissioner. In the case of the controlled revenues there is a foreign Commissioner who has general supervision over the administration of these revenues and he also has substantial authority in the event of default. It was, however, a deliberate aim of the Experts Committee to interfere as little as was consistent with proper protection with the functioning of the German Government. Throughout the operation of the Plan this principle has been adhered to with care.

As has been observed, the obligation of Germany under the Plan is to pay in German currency, to the Agent General for Reparation Payments, a stipulated annuity, and having done that her obligation is discharged; she is not responsible for the transfer of this German currency to the creditor Governments. The Experts Committee, in its report upon this point, said:

> "There has been a tendency in the past to confuse two distinct though related questions, i. e., first the amount of revenue which Germany can raise available for reparation account, and, second, the amount which can be transferred to foreign countries. . . . We propose to distinguish sharply between the two problems, and first deal with the problem of the maximum budget surplus and afterwards with the problem of payment to the Allies."

Reference has been made already to what the Committee did in regard to the first of these problems. Taking up in due course the second question, the Committee decided that the use and withdrawal of the monies deposited in the Reichsbank to the credit of the Agent General for Reparation Payments should be controlled by a Committee, known as the Transfer Committee, which consists of the Agent General for Reparation Payments as Chairman and five other members appointed by the Reparation Commission, one each from America, France, Great Britain, Italy and Belgium. In the language of the report:

> "This Committee will regulate the execution of the programme for deliveries in kind and the payments under the Reparation Recovery Act, in such a manner as to prevent difficulties arising with the foreign exchange.
> "They will also control the transfer of cash to the Allies by purchase of foreign exchange and generally so act as to secure the maximum transfers, without bringing about instability of currency."

The Committee is given broad powers under the Plan and, except in the event of certain rather remote contingencies, its judgment upon any question within its field is final. With regard to the relative importance of the transfer part of the reparation problem, the Experts stated:

> "We are convinced that some kind of coördinated policy with continuous expert administration in regard to the exchange, lies at the root of the reparation problem and is essential to any practicable scheme in obtaining the maximum sums from Germany for the benefit of the Allies."

In his report of November 30, 1926, the Agent General in speaking of the Transfer Committee, said:

> "The Transfer Committee is thus charged with the duty, on the one hand, of providing the maximum possible amount of transfers to the creditor Powers, and, on the other, of protecting the stability of the German exchange. In discharging this heavy responsibility the Committee must naturally look to the terms of the Plan and the London Agreements, but it has at the same time the cardinal advantage of complete independence of thought and action. The members of the Committee

are not open to instructions from any quarter, and in the discharge of their duties under the Plan are always free to act according to their own best judgment."

Enough has been said to indicate the general outline of the Plan and the organization which has been set up to administer it. It may, however, be added at this point, that the German Government has faithfully and promptly fulfilled its obligations under the Plan. There have been a number of questions, any one of which would have been quite sufficient to have caused a quarrel, had it not been that both the German Government and the organization charged with the administration of the Plan, were imbued with a willingness to agree; and these questions, as they arose, were taken up, as business problems usually are, for discussion in a spirit of mutual confidence and a desire to find some acceptable method of accommodation.

Turning next to a brief survey of what has been accomplished under the Plan, the financial results may be mentioned first, not merely because of their own intrinsic importance, but also because their success has favorably influenced other and more intangible results which, when an ultimate appraisement can be made, may well be found to be the Plan's greatest contribution to the post-war settlement. The annuity for the first year amounted to 1,000 millions of gold marks and that for the second year 1,220 millions of gold marks, while the annuity for the third year, now current, is 1,500 millions of gold marks. On account of these annuities, and including certain minor items of interest and exchange, there was actually received by the Agent General within the two and one-half years to February 28, 1927, a total of 2,732 millions of gold marks. The interest and sinking fund of the industrial debentures are payable in semi-annual instalments and other items, such as the transport tax, cannot be determined in amount until some days after the close of the period. It will be understood, therefore, that it is impracticable for the entire amount of each annuity to be in bank before the close of business on the last day of the period.

The disbursements in the first year were 897 millions of gold marks and in the second year 1,183 millions and for the first six months of the third year they were 528 millions, making a total of 2,608 millions. The remaining balance of 124 millions of gold marks does not indicate any difficulty in transfer but is a necessary working balance with which to meet drafts under contracts, of which there is always outstanding a substantial amount, and other forms of transfer payments the totals of which necessarily vary as between months. Emphasis is laid upon this minor point because there has been a mistaken belief in some quarters that reparation funds have been accumulating in the hands of the Agent General.

Out of each annuity there must be paid several items, in the nature of prior charges, before distribution can be made to the creditor Powers. One of the most important of these items is that of the service of the German External Loan of 1924 and there are other items covering the expenses of the various inter-allied commissions, such as the Inter-allied Rhineland High Commission, the Military Commission of Control, which has now ceased to exist, and the expenses of the Reparation Commission in Paris and those of the Office for Reparation Payments in Berlin. During the first two and a half years these charges have amounted to about 11% of the total disbursements, and approximately 89% has represented distributions among the Powers. In the first and second years, approximately 35% of the total disbursements has been transferred by purchasing with reichsmarks, foreign currencies which are either remitted to the creditor Governments or are paid out for their account. The remaining 65% was paid for deliveries in kind and for expenses within Germany of the armies of occupation, expenses of inter-allied commissions and such things. For the current year these figures are not yet available.

Much the largest single item of transfers is that relating to deliveries in kind. For instance, in both the first and the second annuity years, the payments for deliveries in kind aggregated rather more than one-half of the total disbursements for each year, and for the six months of the third annuity year ending February 28, 1927, deliveries in kind were almost exactly 50% of the total disbursements.

Deliveries in kind fall into two groups, the first commonly known as treaty deliveries, that is, deliveries of coal, dye stuffs and chemicals which Germany is required by the Versailles Treaty to deliver on reparation account and, secondly, other deliveries which are made under voluntary contracts which closely approximate ordinary commercial ones. Prior to the Dawes Plan, the Allies called upon Germany for certain deliveries and in so far as these demands were complied with, the German Government settled with its own nationals for the goods delivered. With the inauguration of the Dawes Plan, Germany was relieved of the direct obligation to furnish goods; as has been pointed out, her liability under the Plan is limited to the payment into the Reichsbank of the specified annuities. Moreover, to protect the German economy, it is stipulated in the London Agreement that the programmes for deliveries in kind laid down by the Reparation Commission after consultation with the Transfer Committee, shall be fixed "with due regard to the possibilities of production in Germany, to the position of her supplies of raw materials and to her domestic requirements in so far as is necessary for the maintenance of her social and economic life and also with due regard to the limitations set out in the Experts' Report." It is further stipulated "That it (the German Government) will facilitate as far as possible the execution of the programmes for all deliveries under either the Treaty or the Experts' Report by means of commercial contracts passed under ordinary commercial conditions; and that, in particular, it will not take, nor allow to be taken, any measure which would result in deliveries being unobtainable under ordinary commercial conditions."

Practically speaking, deliveries under commercial contracts are a development under the Dawes Plan. The process is, briefly, as follows: A German seller, in the ordinary course of his business, approaches, say, a French buyer and they make a bargain because they believe the transaction is mutually advantageous. Up to this point there is nothing to distinguish the transaction and it is a matter for agreement between the parties whether the contract shall be carried out on reparation account or under ordinary commercial processes. The parties, however, let us assume, agree that the transaction shall be carried out upon reparation account. This means that copies of the contract are submitted to Reparation officials in Paris, who, in turn, consult with a German Commission, for the purpose of seeing that the class of goods and other details fall within the provisions of the regulations which have been developed under the Plan. The main object of this scrutiny is to insure that the contract does not call for the delivery upon reparation account of more than the quantities specified in the regulations, of certain materials which must be imported into Germany at a cost in foreign currency. Inasmuch as the regulations are known to everyone, comparatively few contracts call for rejection on this account. Another requirement which has to be observed is that the total amount of such contracts for any Power shall not exceed the amount available to that Power on account of its share at the time. Overdrafts are not allowed. Once a contract is approved by the Reparation Commission Office, it is sent to the Transfer Committee for consideration. The machinery works promptly and quietly and when a contract is approved, the parties proceed with its execution in the usual way. The contracts vary in their terms regarding the time and manner of delivery and time of payment. In some cases a contract may be completed in one shipment, while in others the shipments extend over a period of several months. Sometimes payment is to be made upon completion of the contract, while in other cases an advance payment is stipulated; frequently payments on account are required. These things are arranged between the buyer and the seller before the contract is signed. When a payment is due under a contract, the Allied buyer, instead of going to his bank for a draft payable to the German producer, goes to an authorized representative of his Government from whom he secures a draft at five days' sight (although time drafts are used to a limited extent), payable to his own order. He then endorses the draft and delivers it to the German seller (or to his order) who, in turn, discounts it or deposits the draft in his bank for collection, as he may choose. In due course the draft is received by the Reichsbank in Berlin and it presents the draft to the Agent General for acceptance and the amount of the draft, when due, is paid by the Agent General to the Reichsbank out of the annuity funds which are on deposit there.

The regulations under which deliveries are made upon commercial contracts were put into effect on May 1, 1925. Considerable progress was made in the development of this business between that date and August 31st, the end of the first year. During the second annuity year the practice grew and there were submitted to the Transfer Committee 2,559 contracts with French buyers and 1,091 with Belgian buyers. These two countries furnish the bulk of the commercial contracts; Italy's deliveries consist mostly of coal, coke, dye stuffs and pharmaceutical products, while Poland, Serbia, Rumania and the other minor Powers are still taking deliveries under contracts which were made before the Dawes Plan came into existence. Great Britain, outside her army costs, receives her reparations in currency under the Reparation Recovery Act, while in the case of the United States, her army occupation costs are being liquidated by direct cash payments and her mixed claims are being paid under an agreement which was arranged with certain German exporters to the United States.

The goods covered by these commercial contracts comprise all sorts of things necessary to supply economic wants: coal and a wide variety of coal products, refractory products, fertilizers, chemicals, iron and steel, machinery of all sorts, railway supplies, sugar, textiles, horses, cattle and other animals. There were two large contracts in the second year that were of special interest, one, a contract for dredging of the Port of Havre, calling for an expenditure of nearly a million and a quarter of dollars, and the other, a telephone cable contract for Belgium, costing nearly 900,000 dollars. In value, individual contracts range from millions of marks down to a few thousand. A perusal of the reports of the Agent General makes it evident that the deliveries in kind have contributed directly and effectively to the restoration of the comforts and conveniences of the war torn countries. The imagination is touched by the record of such things as the deliveries to Serbia of railway and street cars to a value of more than four million dollars; agricultural, textile and other machinery of a million and a quarter of dollars; mining, bridge building and similar material of another million and a quarter; telephone and telegraph apparatus of nine hundred thousand dollars; hospital and medical supplies costing three hundred thousand dollars. Rumania received locomotives, cars and rails amounting to more than two million dollars, while Greece was assisted to meet its refugee problem by the delivery to it on reparation account of wooden houses costing three quarters of a million dollars.

The problems related to deliveries in kind have been the subject of considerable speculation and discussion and their ultimate effects cannot yet be measured. The Experts in their report said:

> "We have given special attention to the question of deliveries in kind: in their financial effects, deliveries in kind are not really distinguishable from cash payments, and they cannot in the long run exceed the true surplus of German production over consumption available for export without either upsetting the exchange or rendering foreign loans necessary."

Deliveries in kind were, however, provided for in the Treaty of Versailles and were being made pursuant thereto when the Dawes Plan went into effect. The Plan, therefore, did not originate the practice but it had to deal with an existing arrangement. The Experts recognized, moreover, that as a part of a going system, several of the Allied countries were dependent upon deliveries in kind, and to stop them would cause dislocation. Furthermore, they felt that within reasonable bounds, deliveries in kind might represent a stimulus to German productivity. They might also assist in making transfers. These hopes of the Experts appear to have been well founded. Deliveries in kind have gone forward with general satisfaction both in Germany and in the receiving countries. Especially, it would seem that the system of deliveries under commercial contracts is helpful as a means of restoring the channels of trade which had been broken up by the war. Under these contracts the German producer deals with a buyer whose credit is safe, while at the same time the purchaser secures from his Government some incidental advantages by making his purchase upon reparation account. German producers of a wide range of products, are being brought again into contact with Allied buyers. These recent antagonists are finding it possible to do business together, and thus the fabric of international trade which was torn asunder in the war, is, in part, being restored as an incidental contribution to reparation payments.

The payments by Germany and the transfers to the creditor Powers have been accomplished in the face of many real difficulties and of much hard work. Among other things, it was necessary to procure a protocol between Great Britain and Germany regarding the Reparation Recovery Act and to negotiate an agreement with Germany providing for the liquidation, in the third annuity year, of contingent liabilities which would have fallen, with probably detrimental effects, into the fourth and fifth years. However, goodwill and understanding on both sides have grown month by month and these have made it possible to solve the problems that have arisen in the past and this spirit constitutes a bright promise for the success of the further operation of the Plan.

Aside from its financial results, the Plan has marked a starting point for, and has been a contributing factor in, the economic and political stabilization of the western European countries which has come since 1924. One marked effect which can be attributed directly to the Plan, is the renewal in the German people of confidence in themselves and of hope for their future. The post-war period not only destroyed the German currency and wrecked the fortunes of vast masses, but it undermined the morale of the people. So serious was this condition that it was generally expected that a long time must elapse before morale would be restored. Happily, this prediction has proved to be unfounded. At the same time, the Plan made it possible for other nations, particularly America, to make loans and extend credits to German commerce and industry and thus supply the working capital which was necessary to enable them to function. Indeed, for a while American bankers were so eager to secure German loans that sometimes it looked as though the life giving stream was dangerously near to a flood stage. While the better class of bankers arranged loans and credits with discretion and care, others, in the early months of the Plan, rushed in with almost childlike simplicity. Before 1924 few American bankers had more than a limited experience in making foreign loans and it is to be feared that most of them have followed too closely the methods which had been developed in connection with domestic loans. Sufficient care was not always taken to adapt American methods to foreign conditions, and some good business has gone to other centers because of the onerous and inflexible conditions laid down by American bankers. Among other things, our cumbersome and complicated form of legal documents, which few laymen here have ever pretended to understand, is a good deal of a shock to foreign business men who have perhaps an over-appreciation of the efficiency of our business methods and practices.

Another highly significant development in Germany since 1924 has been the growth of an internal money market. In April, 1924, just about the date of the report of the First Committee of Experts, the Reichsbank, in order to protect the currency, instituted a strict rationing of credit. For months thereafter, the credit situation was analogous to the food situation in a besieged city where the inhabitants are allowed a quantity of food just sufficient to sustain life. After the German External Loan was floated, which provided a sound backing for the German currency, the rationing policy was gradually relaxed but it was not until near the end of 1925 that it became unnecessary. In the autumn of 1924 during the early months of the Plan, money was scarce and interest rates were high, the day to day rate being 16% in the middle of October and just under 11% at the end of December. On current deposit accounts the banks at first paid 6% but reduced the rate to 5% about November, 1924. Savings bank deposits and life insurance funds had been almost wholly destroyed by the inflation. To the surprise and gratification of everyone, the savings banks began at once to show signs of life. In spite of low wages and a small volume of business, the common people manifested a gratifying degree of confidence in the new reichsmark currency which was established under the Plan. That picturesque and significant phrase, "The flight from the mark," was no longer heard. At the end of the first annuity year, August 31, 1925, savings bank deposits were reported at 1,304 millions of reichsmarks and at the end of the second year they had increased to 2,591 millions of reichsmarks. An interesting fact in this connection is that while the total savings bank deposits in Germany are, as yet, only about 16% of the pre-war deposits, the annual increase, aside from interest allowed on deposits, which before the war was of course a large item, is now greater than it was in the years preceding the war. In 1925, interest rates continued to fall, and short term money was reasonably plentiful, partly because of the accumulation of savings and profits among the German people themselves, and in larger part, no doubt, because of the loans and credits from abroad. Throughout 1925 there were no public offerings in Germany of domestic security issues, but in the early summer of 1926 offerings began to appear, and the internal market developed astonishing resources. For the whole year of 1926 the domestic issues in Germany amounted to about 1,350 million reichsmarks as against about 1,700 million reichsmarks of foreign loans; in other words, about 44% of the total public issues of securities in Germany in 1926 were offered upon, and absorbed by, the domestic market. In addition to these issues there were sold over the counter, in accordance with the usual practice, a large quantity of mortgage bonds, and also a substantial amount of new issues of capital shares was absorbed.

Had anyone in 1924 predicted the development within this short time of such an internal money market in Germany, he would have been dismissed as a visionary unworthy of credence. Its existence is a fact, however, and a fact which has much significance for American bankers. It would only weary you, even if time permitted, to refer to other developments within Germany, such as the growth in the sales of the coöperatives, the reduction of unemployment and the progress that has been made in the reduction of costs and the increase of production that has grown out of the widespread and intensive study that has been, and is still being given in Germany to problems of business organization and processes of manufacture.

As we have already seen, the Experts Committee tried to provide a sense of security that would permit the German economy to proceed in its reconstruction in an orderly way. The German people have responded to this appeal of the Plan and their success has outrun expectations. The German people know that upon the economic side, the Plan has been their salvation. Their currency has been stabilized and the one external factor which might disturb the stability of the currency, that is, reparation payments, is under the control of the Transfer Committee which is charged with the duty of safeguarding the currency. This Committee, as we have seen, is clothed with broad powers. From my intimate knowledge of the character and the courage of the men who, as members of the Transfer Committee, are answerable to their own consciences alone for their acts within the provisions of the Plan, I know that they will not shirk their duty and that their ability and foresight are the best assurance that crises will be avoided.

Upon the political side, the Plan has also borne fruits of great importance. Out of an atmosphere of bitterness and hatred there has come a measure of peace and goodwill that is quite as surprising as any of the financial results. This is not the time nor the place to attempt to appraise the political situation between Germany and her former enemies. It is enough to remind you of the agreements that have been made during the past two years and of those other projects such as the ones mentioned in connection with Thoiry, which, in the interests of world welfare, let us hope, are not dead but merely sleeping. If the policies which were followed from the close of the war to 1924 were those of destruction, the Dawes Plan can fairly claim to be a policy founded upon justice which continues to be a contributing factor in the growth of constructive policies outside of and beyond its own field.

When we look to the future, we often hear around us the voices of the prophets of gloom. Many, speaking in a doctrinaire manner, are convinced that the Dawes Plan must break down—they say there is no hope for it. Other observers are no less certain that Germany can continue to pay and that the full annuities can be successfully transferred. Both groups can not be right and perhaps some misapprehension enters into the calculations of both. If the Dawes Plan was a final, rigid thing like a mortgage, there might be more occasion for concern. The Plan, however, is not an inflexible piece of mechanism fastened on the back of the German Government. It must be remembered that the annuities fixed by the Experts Committee had to be determined at a time when financial and economic conditions in Europe, and particularly in Germany, were much befogged. The Committee had to make its forecasts under these difficult conditions and to make these forecasts for a period of several years. Without yielding in our admiration of what they accomplished, it would not be surprising if it should be found experimentally that some degree of error crept into their forecasts. They recognized that possibility themselves and like wise men they took care to guard against unhappy results in such an event. Moreover, and this point seems to be overlooked by many, the Plan itself is not a final settlement. In its report, the Experts Committee stated:

> "We would point out finally that while our plan does not, as it could not properly, attempt a solution of the whole reparation problem, it foreshadows a settlement extending in its application for a sufficient time to restore confidence, and at the same time is so framed as to facilitate a final and comprehensive agreement as to all the problems of reparation and connected questions as soon as circumstances make this possible."

Events are moving, the will to agree is growing, and it is not unreasonable to hope that it will not be long until the final and comprehensive agreement foreseen by the Experts Committee will become a reality. The questions yet to be settled are delicate and of a nature easily provocative of quarrels, but the problems can be settled in a friendly way if approached in the right spirit. The situation at present calls for patience and an effort to understand. In particular, there should be everywhere a restraint upon criticism. Apparently with this thought in mind, the Minister of Foreign Affairs of France, M. Briand, was reported recently as saying:

> "I do not understand why public opinion impatiently confuses international politics with motion pictures, whose scenes must be reeled off at high speed. What is significant is that, thanks to the confidence imposed in Dr. Stresemann and myself by our countries, things have become possible which two years ago would have seemed quite impossible."

The future of reparations may be faced today with confidence, and for the past, I know of no more satisfying tribute to the work of the Experts Committee and to the administration of the Plan than a statement in a Paris paper on February 12, 1927, which was penned by M. Jacques Seydoux, who had then just retired from a long and honorable career in the French Government service. He said:

> "Thanks to it (the Dawes Plan), the question of reparations, which not only aroused Germany against the Allies but involved the risk of embroiling the Allies among themselves at any moment, was taken out of the political field and transferred to the domain of technique. The Germans had such an interest in the restoration of their financial situation, and their industrialists needed credit so badly, that they accepted without hesitation the very severe clauses on control which the Plan contained. The fact is that everybody did his bit, and that a general goodwill succeeded the greatest possible badwill; confidence replaced distrust, and for two and a half years the Dawes Plan has been functioning without difficulty; differences of opinion have been settled without trouble either directly or by arbitral verdicts which everybody has accepted; Germany is enjoying a stable currency and a financial prosperity which increases every day, while the Allies are receiving what is due them."

# AMERICAN INSTITUTE OF ACCOUNTANTS EXAMINATIONS

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants, May 19 and 20, 1927.]

## Examination in Auditing

MAY 19, 1927, 9 A. M. TO 12 : 30 P. M.

*The candidate must answer all the following questions:*

No. 1 (10 points):

Describe briefly a cash audit. What is the purpose of a cash audit and what are its limitations?

No. 2 (5 points):

Define briefly and give examples of:

(a) Current assets.
(b) Current liabilities.
(c) Fixed assets.
(d) Intangible assets.

No. 3 (10 points):

What means may be used for verifying the correctness of the following items on the books of a business concern?

(a) Bank balances.
(b) Notes receivable which have been sent to bank for collection.
(c) Securities which have been pledged as collateral for loans.
(d) Indebtedness for money borrowed from banks.
(e) Indebtedness on notes payable which have been sold through note brokers, the present holders being unknown to the makers.

No. 4 (15 points):

Prepare a list of all important matters with reference to the item of inventories which require attention in making a balance-sheet audit.

No. 5 (10 points):

Why is it essential that any hypothecation of assets, or any liens existing thereon, be disclosed in a balance-sheet? Indicate the steps you would take to ascertain whether or not any part of the inventory of a manufacturer has been pledged to secure loans or advances.

No. 6 (10 points):

Among the accounts receivable of the Mississippi Company, which aggregate approximately $1,000,000, you find the following:

Account of $50,000 for sales during the previous month to the Jonesboro' Dry Goods Company, 75 per cent. of whose capital stock is owned by the Mississippi Company. Sales to this company are settled promptly in 30 days.

Account of $130,000 representing principally advances to the Memphis Metal Company (95 per cent. of whose capital stock is owned by the Mississippi Company) to enable it to make additions to its plant. A considerable part of the output of the Memphis Company is sold to the Mississippi Company at prices advantageous to the latter for use in its manufacturing operations.

Account of $25,000 for advances to the Bluestone Sales Company, all of whose capital stock is owned by the Mississippi Company, but which has a bonded debt of $100,000 to others than the Mississippi Company. The advances were made principally to enable the Bluestone Company to continue in business in spite of losses sustained for several years past.

Account of $28,000 for advances to the president of the company who expects to pay it off during the next two years out of the percentage of the company's profits which is payable to him (if earned) under contract.

What examination, if any, other than that which you would make of ordinary customers' accounts, would you deem desirable or necessary in the case of each of the foregoing accounts? What treatment would you give these accounts in stating the balance-sheet of the Mississippi Company, (a) if it be a consolidated balance-sheet, or (b) if it be a non-consolidated balance-sheet?

No. 7 (10 points):

State several reasons for the compilation of "audit papers" and, without naming each paper, describe what they should comprise.

No. 8 (10 points):

You have been retained by the executors of a recently deceased member of a firm, which operated a silk-manufacturing business, to determine the fair value of his interest in the firm. What matters, if any, would you take into consideration other than those included in the usual periodical audit of the firm's accounts? Describe your procedure with respect to any such special questions.

No. 9 (10 points):

In making a detailed audit, describe how you would satisfy yourself that the sales had been properly accounted for in three of the following five cases:

(a) An automobile manufacturer.
(b) A bituminous coal operator.
(c) A manufacturer of heavy machine tools.
(d) A silk-dress-goods manufacturer.
(e) A building contractor.

No. 10 (10 points):

May a certificate of a balance-sheet be qualified without necessarily reflecting on the validity of the balance-sheet? If in your opinion such may be the case, state the conditions and write two certificates as illustrations.

## Examination in Accounting Theory and Practice

### PART I

MAY 19, 1927, 1 P. M. TO 6 P. M.

*The candidate must answer questions* 1 or 2, 3 or 4 *and* 5 or 6.

No. 1 (47 points):

The Arlington Silk Mills incorporated a selling company in France, as of January 1, 1926, to take over the assets and liabilities of their Paris office at that date, which were as follows:

*Assets*

| | |
|---|---|
| Cash | Fcs. 134,000 |
| Accounts receivable | 680,000 |
| Merchandise at invoice price, plus freight charges, etc. | 1,050,000 |
| Furniture and fixtures | 40,000 |
| | Fcs. 1,904,000 |

*Liabilities*

| | |
|---|---|
| Accounts payable | Fcs. 23,800 |
| Arlington Silk Mills—current account | 1,780,200 |
| Capital stock | 100,000 |
| | Fcs. 1,904,000 |

The exchange rate at January 1, 1926, was 3.70 cents to the franc. During the year, merchandise costing $160,000 was shipped by the Arlington Silk Mills and billed at 10% above cost, and remittances amounting to 5,000,000 francs were made by the French company, the details being as follows:

| *Merchandise invoiced* | | | *Remittances* | | |
|---|---|---|---|---|---|
| 1/16 | $30,000 @ | .0373 | 2/20 | Fcs. 500,000 @ | .0356 |
| 3/27 | 20,000 " | .0342 | 6/12 | 1,000,000 " | .0287 |
| 5/ 6 | 50,000 " | .0324 | 7/10 | 800,000 " | .0254 |
| 8/14 | 40,000 " | .0275 | 8/28 | 1,000,000 " | .0284 |
| 10/16 | 36,000 " | .0286 | 11/27 | 700,000 " | .0360 |
| | | | 12/12 | 1,000,000 " | .0379 |
| | $176,000 | | | Fcs. 5,000,000 | |

The trial balance of the French company at December 31, 1926, forwarded to the American company, was as follows:

| | | |
|---|---|---|
| Sales | | Fcs. 7,730,000.00 |
| Merchandise purchased | Fcs. 5,645,581.46 | |
| Merchandise inventory | 1,050,000.00 | |
| Freight charges | 580,000.00 | |
| Warehouse charges | 213,000.00 | |
| Salaries | 474,000.00 | |
| General expenses | 306,000.00 | |
| Selling expenses | 117,000.00 | |
| Accounts receivable | 1,610,000.00 | |
| Cash | 284,000.00 | |
| Furniture and fixtures | 50,000.00 | |
| Accounts payable | | 73,800.00 |
| Arlington Silk Mills | | 2,425,781.46 |
| Capital stock | | 100,000.00 |
| | Fcs. 10,329,581.46 | Fcs. 10,329,581.46 |

The inventory at the end of the year amounted to 1,412,000 francs, which included freight charges, etc., of 140,000 francs, the exchange rate at that date being 3.90 cents to the franc.

Prepare a balance-sheet and profit-and-loss account, in dollars, for consolidation with the accounts of the American company and submit the journal entries necessary for the purpose on the books of the company.

No. 2 (47 points):

The Kroy Manufacturing Company acquired all the assets of the Pioneer Development Company as set forth in the accompanying balance-sheet, as at December 31, 1925, and thereafter operated the plant as a branch.

VENDOR COMPANY
Balance-sheet—as at December 31, 1925

| | | |
|---|---|---|
| *Assets* | | |
| Current assets: | | |
| Cash | | $79,592.81 |
| Customers' notes and accounts receivable— | | |
| Notes | $153,460.23 | |
| Accounts receivable | 495,816.44 | |
| | | 649,276.67 |
| Inventories at cost or market (the lower)— | | |
| Raw materials and supplies | $173,651.83 | |
| Manufactured goods and goods in process | 393,598.17 | |
| | | 567,250.00 |
| Total current assets | | $1,296,119.48 |
| Prepaid expenses: | | |
| Insurance, interest and taxes | | $15,876.29 |
| Fixed assets: | | |
| Land | $123,978.15 | |
| Buildings | 571,836.32 | |
| Machinery and equipment | 929,117.19 | |
| Office furniture and fixtures | 17,824.01 | |
| | | 1,642,755.67 |
| Patents (amortized value) | | 500,000.00 |
| Goodwill | | 750,000.00 |
| | | $4,204,751.44 |
| *Liabilities* | | |
| Current liabilities: | | |
| Notes payable—banks and brokers | | $175,000.00 |
| Accounts payable—trade creditors | | 214,014.32 |
| Accrued liabilities: | | |
| Interest, state and local taxes | | 25,648.19 |
| Wages | | 3,519.26 |
| Provision for federal taxes: | | |
| Year 1925 | | 47,829.56 |
| Prior years | | 83,012.34 |
| Total current liabilities | | $549,023.67 |
| Funded debt: | | |
| First mortgage 6% bonds, maturing April 30, 1927 | | 600,000.00 |
| Reserves: | | |
| Depreciation | $221,834.65 | |
| Bad debts | 10,154.89 | |
| Decline in market of manufactured product | 35,000.00 | |
| General reserve | 75,000.00 | |
| | | 341,989.54 |

| | |
|---|---|
| Capital stock issued: | |
| Preferred—10,000 shares, 6% cumulative.............. | $1,000,000.00 |
| Common—217,500 shares, no par value, declared value... | 1,087,500.00 |
| Capital surplus........................................ | 268,919.05 |
| Earned surplus......................................... | 357,319.18 |
| | $4,204,751.44 |

The consideration agreed upon was as follows:

(1) Cash to retire the preferred stock at a premium of 10%;
(2) The assumption of all liabilities except federal taxes for the years prior to 1925;
(3) Payment in cash equal to $2.50 per share on the common stock;
(4) The issuance of one share of the Kroy Manufacturing Company's common stock, par value $100, for every fifteen shares of the vendor company.
(The market value of the Kroy Manufacturing Company's common stock was $125.)

The Development Company was liquidated forthwith and a complete distribution made to the stockholders. The expenses of liquidation amounted to $6,162.66 and the federal taxes for the period prior to 1925 were assessed and paid at the amount provided therefor in the balance-sheet.

Prepare journal entries to record the transactions on the books of both the vendor and purchasing companies and close the accounts of the former, showing particularly the account with the Kroy Company, the stockholders' and cash accounts.

No. 3 (17 points):

The proprietor of a business receives from the bookkeeper a statement of net sales, profits and percentages of profits of five departments for two half-yearly periods.

He notices that each of the five departments shows a decreased percentage of profit for the second half-year, in face of the fact that there is an increase in total sales and the total profit for the latter period is greater than that for the former.

With the idea that something might possibly be wrong, he asks you to review the figures and to give reasons for the apparent inconsistency.

Prepare your explanation in the form of a report from the statement presented, which is as follows:

| | *First half-year* | | |
|---|---|---|---|
| Department | Sales | Net Profit | Percentage of profit |
| A.................... | $8,750 | $962.50 | 11% |
| B.................... | 19,800 | 1,485.00 | 7½ |
| C.................... | 21,250 | 1,062.50 | 5 |
| D.................... | 8,250 | 1,237.50 | 15 |
| E.................... | 10,920 | 1,337.70 | 12¼ |
| | $68,970 | $6,085.20 | |

| Department | *Second half-year* Sales | Net profit | Percentage of profit |
|---|---|---|---|
| A.................... | $19,120 | $1,912.00 | 10% |
| B.................... | 10,870 | 760.90 | 7 |
| C.................... | 8,080 | 363.60 | 4½ |
| D.................... | 18,940 | 1,799.30 | 9½ |
| E.................... | 15,830 | 1,899.60 | 12 |
| | $72,840 | $6,735.40 | |

No. 4 (17 points):

You are requested to make a balance-sheet examination as at December 31, 1926, of the A Company, engaged in the manufacture of machinery.

During your examination, you are informed that the inventory has been valued at cost, as reflected by detailed job-cost records on file. A study of the job-cost system, under which the inventory has been valued, indicates that factory burden has been absorbed in costs as a percentage of direct labor. The company's operating accounts tend to show that a considerable balance of unabsorbed factory burden has accumulated during the year, in spite of the fact that the plant was operated to capacity during the entire calendar year 1926.

(1) What are your conclusions regarding inventory valuation based upon the information cited above?

(2) What adjustment, if any, would you make in the total valuation of the inventory at December 31, 1926?

(3) If an adjustment in inventory valuation were necessary, how would you make it?

No. 5 (36 points):

On January 1, 1927, a corporation floated a bond issue of $300,000 to be retired serially over a period of eight years as follows:

| | | | |
|---|---|---|---|
| Dec. 31, 1927....... | $10,000 | Dec. 31, 1931.......... | $30,000 |
| " " 1928....... | 15,000 | " " 1932.......... | 35,000 |
| " " 1929....... | 20,000 | " " 1933.......... | 40,000 |
| " " 1930....... | 25,000 | " " 1934.......... | 125,000 |

Discount and expense of issuing the bonds amounted to $33,000.

Draft a schedule, showing how much of such bond discount and interest you would claim as a deduction from gross income, for federal income-tax purposes, for each of the years 1927 to 1934 inclusive.

No. 6 (36 points):

Corporation A has contracts with its sales and production managers whereunder each of the latter is to receive, as extra compensation, two and one-half per cent. of the net book profit of the company for the calendar year 1926, after providing for federal income taxes.

The net book profit for the calendar year 1926, before provision for the extra compensation and for federal income taxes, was $95,000. There were, however, deductions amounting to $5,000 included in the net book profit as stated above, which were unallowable for income-tax purposes.

From the foregoing data, compute the amount of federal income tax payable by the corporation and the amount of extra compensation due to each of the managers.

## Examination in Commercial Law

MAY 20, 1927, 9 A. M. TO 12:30 P. M.

*Answer ten questions and no more—three on negotiable instruments; three on contracts; two on federal income tax, and one each on partnership and corporations.*

*Give reasons for all answers.*

### CONTRACTS

No. 1. Prepare a simple contract with the essential elements arranged in separate paragraphs. Point out the essential elements.

No. 2. How may a seller ship goods to a purchaser, retaining title in himself until the purchase price is paid? How is title then passed when the purchaser makes payment?

No. 3. On May 1, 1927, Shearman signed and sealed a formal written offer to sell to Allen at any time on or before May 15, 1927, certain merchandise at a specified price. On May 5, 1927, Shearman wrote Allen that the offer was canceled and withdrawn. Upon receipt of that letter on May 6, 1927, Allen formally accepted the offer and thereafter sued to enforce the contract. What decision would you render in the action?

No. 4. What is the effect on a contract where a party to it (a) is declared a bankrupt and receives a discharge in bankruptcy; (b) makes a general assignment for the benefit of creditors? What, if any, is the distinction between the two cases?

NEGOTIABLE INSTRUMENTS

No. 5. Is the following a negotiable instrument?

Topeka, Kansas,
Jan. 10, 1927.

To *George W. Brown*, Topeka, Kansas:

Pay to the order of Fred L. Jones $2,000 on account of contract between you and the undersigned.

(Signed) JAMES A. SMITH.

Accepted
(Signed) GEORGE W. BROWN

No. 6. What must a negotiable instrument not contain? What are the exceptions to this rule?

No. 7. A note payable to Moore or order is endorsed "Pay to Neil Bartlett for collection" over Moore's signature. It is then endorsed "Pay to Fred Downs" over Bartlett's signature. Downs collects the amount of the note from the maker. To whom does the money belong?

No. 8. Give an example of a case in which a holder with notice is a holder in due course.

CORPORATIONS

No. 9. X insured certain buildings owned by him with Y Fire Insurance Company against damage by windstorm or tornado, paying the required premium therefor. While the policy was in force the buildings were damaged by wind. When X sought to recover the amount of his damages the company contended as a defense that wind or tornado insurance was not within the scope of its charter powers and that the policy was therefore void. Was such defense good?

No. 10. What is a corporation *de facto?* a corporation *de jure?*

PARTNERSHIP

No. 11. A decides to go into a retail business and to enable him to do so B and C lend A the sum of $10,000 for one year under an agreement in which A agrees to pay to B and C as interest on such loan 5 per cent. of the net profits of the business for one year. Subsequently the X Company, which has sold goods to A, brings suit against A, B and C as copartners, for the unpaid purchase price. Does X corporation recover against B and C?

No. 12. What risks would you deem to be important for careful consideration before you would enter into copartnership with another?

INCOME TAX

No. 13. In 1925 A, a stock broker, has income (after deduction of personal exemptions) of $7,000, but he has suffered a loss of $40,000 in the stock market so that his return for 1926 shows a net loss of $33,000. Can such net loss be used as a deduction from A's gross income in returns for any years subsequent to 1925?

No. 14. The W Company owns a large loft building, part of which it occupies and the balance of which is leased to various tenants under 5-year leases beginning January 1, 1926. In 1926 the company paid out $25,000 to real-estate brokers as their commissions for securing the tenants and for the making of the leases. Is the sum so paid out a proper deduction for income-tax purposes for the year 1926? If not, how is such sum deductible?

## Examination in Accounting Theory and Practice

### PART II

MAY 20, 1927, 1 P. M. TO 6 P. M.

*The candidate must answer questions* 1 or 2, 3 or 4 *and* 5 or 6.

No. 1 (48 points):

A fire-insurance company is formed, January 1, 1926, with a capital of $500,000 and paid-in surplus of $250,000. It expects to conduct a business that will result in a premium income (after deducting re-insurance and return premiums) for the first two years of $360,000 and $450,000 respectively and of not less than $630,000 for each succeeding year.

It is desired to keep the commission cost within 25 per cent. and the other operating expenses at $100,000 each year.

For the purpose of the reserve for unearned premiums, it may be assumed (a) that June 30th is the average date of expiry of all premiums and (b) that the premium income is equally divided between one-year, three-year and five-year policies. For the purpose of interest, you may assume that the company received from its investments $40,000 the first year, $50,000 the second year and $60,000 each year thereafter.

You are required to make an estimate of income and expense, in tabular form, for the first five years ending December 31st, assuming the fire-loss ratio to premium income earned to be 50 per cent. Show how much higher a ratio than 50 per cent. the company could bear each year without impairing its capital.

No. 2 (48 points):

You are requested to make a balance-sheet audit of the records of the Arctic Fisheries Corporation, operating fish canneries on Puget Sound and the coast of Alaska.

This corporation has been in operation for one year, having acquired the properties of the Alaska Fisheries Corporation on December 31, 1925, at an agreed price, subsequent to an appraisal of all fixed assets.

A condensed list of balances, as at December 31, 1926, is presented as follows:

| | *Dr.* | *Cr.* |
|---|---|---|
| Cash in banks and on hand | $167,163 | |
| Accounts receivable, trade | 140,980 | |
| Inventory—canned salmon | 102,412 | |
| Inventory—supplies | 25,615 | |
| Advances to fishermen | 66,965 | |
| Real estate | 122,500 | |
| Buildings | 518,213 | |
| Labels, trademarks, etc. | 24,000 | |
| Equipment | 325,337 | |
| Ships | 330,000 | |
| Cost of sales | 1,366,812 | |
| Selling expenses | 42,617 | |
| Discounts allowed | 10,614 | |
| Administrative expenses | 47,886 | |
| Depreciation expense | 30,807 | |
| Interest on bonds | 15,000 | |
| Accounts payable | | $127,320 |
| Accrued taxes | | 14,219 |
| Reserve for bad debts | | 11,646 |
| Reserve for depreciation | | 30,807 |
| Bonded municipal assessments | | 12,500 |
| Six per cent. gold bonds | | 500,000 |
| Sales—canned salmon | | 1,615,429 |
| Capital | | 1,000,000 |
| Capital surplus | | 25,000 |
| | $3,336,921 | $3,336,921 |

In the course of your audit, the following facts are disclosed:

(1) On December 20, 1926, a dividend of 5% on outstanding capital stock, payable January 2, 1927, was declared by the directors.

(2) Cheques were drawn during the first ten days of January, 1927, but were entered in the cashbook under date of December 31, 1926, and applied as follows: on accounts payable $47,036 and for wages $6,739.

(3) During the year, salesmen and other employees had borrowed money from the corporation amounting to $20,000 which was offset by personal cheques received and deposited in the company's bank on January 6, 1927, and entered in the cashbook under date of December 31, 1926. An amount of $10,642 was also collected in the early part of January, 1927, on accounts receivable and this was handled in like manner.

(4) The bonds were secured by a first mortgage on all real estate, buildings, equipment and other fixed assets and carried interest at the rate of 6% per annum, payable semi-annually on January 1st and July 1st. The trust deed contained the following provisions:

(a) That net current assets of $250,000 must be maintained and in no event shall current assets be less than twice the current liabilities.
(b) Current assets to include cash, good current and collectible trade accounts and trade notes receivable, also fishermen's accounts and all inventories.
(c) Current liabilities to include all liabilities except bonds and unmatured instalments on property liens.

(5) Reviewing the operating items for previous years, you find that annual depreciation expense on the old company's statements is approximately the same as for the year 1926, viz.: $30,807, although the fixed asset values are much larger on the new company's books in accordance with the appraisal. Further inspection shows that the rates of depreciation used by the old company (which were considered proper) have been reduced 50% in computing depreciation for 1926, so that the depreciation expense will not be increased as the result of the increase in asset values.

(6) From an analysis of the "ships" account and from information furnished, you find that the following vessels were taken over, at book value, from the old company: steamships Issaquah $40,000, Klondike $40,000 and Dawson $35,000; sailing ships Juneau $15,000 and Skagway $10,000; gasoline boat Mermaid

$25,000. The sailing vessels had been discarded in 1925 and, although valued at $25,000, had a scrap value of not more than $3,500.

In December, 1926, the company purchased two steamers; the Senator costing $90,000 and the Nome $75,000. These boats took the place of all the old equipment which was offered for sale and realized prices in January, 1927, as follows: Issaquah $10,000, Dawson $8,000 and Mermaid $12,000. The Klondike (a sister ship of the Issaquah), the Juneau and the Skagway were retained.

Depreciation on boats was taken, during 1926, as follows: Issaquah $1,000, Klondike $1,000, Dawson $875 and Mermaid $625, a total of $3,500.

It is claimed by the directors that the loss to be sustained on the replacing of the old boats would be more than offset by the appreciation in value of the new steamers, which were bought at a bargain, and you are shown a valuation by a trustworthy appraiser rating these vessels as follows: the Senator $225,000 and the Nome $200,000.

(7) Included in "advances to fishermen," you find charges for nets, etc., amounting to $20,146. These represent the property of the company. The nets, etc., are lent to the fishermen and debited to their accounts as a matter of record. The fishermen are required to maintain the nets in good condition.

From the foregoing data, make what adjusting journal entries you consider necessary. Prepare and submit a balance-sheet with any comments you think appropriate.

No. 3 (20 points):

The capital stock, authorized and outstanding, of the Sabine Corporation consists of 3,000 shares of 6% cumulative preferred stock and 7,500 shares of common stock, all being of the par value of $100 each. The former is preferred both as to capital and to dividends, and the preferred dividends, payable June 30th and December 31st, have been paid to December 31, 1925.

The balance-sheet, as of December 31, 1926, prepared by the company, was as follows:

*Assets*

| | | |
|---|---|---|
| Current assets: | | |
| Cash | | $23,000 |
| Customers' accounts receivable | $147,500 | |
| *Less:* Reserve for bad debts | 2,500 | |
| | | 145,000 |

| | | |
|---|---|---|
| Inventories at cost: | | |
| Raw materials and supplies | | $95,000 |
| Manufactured goods and goods in process | | 167,000 |
| Total current assets | | $430,000 |
| Prepaid expenses | | 1,700 |
| Fixed assets: | | |
| Land | | 75,000 |
| Buildings | $325,000 | |
| Machinery and equipment | 560,000 | |
| | 885,000 | |
| *Less:* Reserve for depreciation | 210,000 | |
| | | 675,000 |
| Total | | $1,181,700 |

*Liabilities*

| | |
|---|---|
| Current liabilities: | |
| Notes payable—banks | $125,000 |
| Accounts payable—trade creditors | 204,200 |
| Accrued liabilities—interest and state taxes | 7,500 |
| Total current liabilities | $336,700 |
| Reserve for contingencies | 50,000 |
| Stockholders' equity: | |
| Excess of assets over liabilities | 795,000 |
| Total | $1,181,700 |

You are required to comment on the statement (balance-sheet), as presented and to make such changes in form as you consider appropriate or desirable.

No. 4 (20 points):

Two firms of lawyers—J & K and L & M—decided to amalgamate as at January 1, 1926.

J & K have receivable accounts $8,000, furniture valued at $5,000 and a law library worth $2,500. L & M have receivable accounts $5,500, furniture valued at $3,500 and a law library worth $1,500.

Each firm introduces $5,000 cash, as working capital, and pays off its own liabilities prior to the amalgamation.

The firms guarantee their respective accounts receivable and are to be charged with losses on collection. It is further agreed that each firm shall have a preferential claim of 20% on the gross fees billed during the year 1926 to their own clients. The balance of the net earnings, after charging all expenses, is to be divided as follows: J 35%, K 25%, L 25%, M 15%. The shares of the partners in the assets of the amalgamated firm are to be in the same proportions.

The shares of the partners in the preferential claims of 20% are to be: J seven twelfths, K five twelfths, L five eighths, and M three eighths.

The accounts for the year ended December 31, 1926, showed total earnings of the firm as $65,000, of which $30,000 came from J & K's clients, $25,000 from L & M's clients and $10,000 from new clients. Accounts receivable unpaid (included in the $65,000) amounted to $15,000.

The loss on collection of the original accounts receivable averaged 7% on J & K's accounts and 4% on those of L & M.

Personal withdrawals, which were to be treated as advances against net earnings and not as salaries, were J $5,000, K $6,000, L $3,000 and M $4,000. No interest was to be charged on withdrawals and none allowed on capital.

Working expenses for the year amounted to $20,000.

After depreciating all furniture 15% and each library 30% for the year, prepare accounts showing the distribution of net earnings and a balance-sheet as of December 31, 1926.

No. 5 (32 points):

On December 31, 1926, all the outstanding stock of a corporation (5,000 shares, common, having a par value of $100 a share) was owned by two stockholders, one of whom (Smith) held 4,500 shares and the other (Brown) 500. Earned surplus amounted to $450,000.

To enable Smith to retire from the business and to place Brown in control, a recapitalization was effected in the following manner:

An appraisal of the plant—real estate and machinery—was made, the result being an increase in sound value thereof over the net book value of $1,000,000. Six per cent. sinking-fund gold bonds for $1,000,000, secured by a first mortgage on the plant, were issued at a cost to the corporation of $115,000, representing discount and expense, and with the proceeds therefrom Smith's stock was purchased by the corporation and taken into the treasury at an agreed price of $250 a share. Such treasury stock was then voted out in the form of a dividend in stock to Brown. The corporation then called in all Brown's stock and issued to him in return 500 shares of new preferred stock having a par value of $100 a share and 30,000 shares of new common stock having no par value.

(a) Formulate the journal entries you would use to record the foregoing transactions;

(b) Submit a statement showing the aggregate capital, after refinancing, and the amount of each class thereof, i. e. funded debt, preferred stock, common stock and surplus (if any). Explain the method used in assigning a value to the no-par common stock. How much, if any, of the original earned surplus of $450,000 could, in your opinion, be retained as surplus available for dividends? Give reasons for your decision.

NOTE. The corporation being dealt with was incorporated in a state in which there is no law governing the nominal value of no-par-value stock.

(c) Regardless of the amount of depreciation of fixed assets allowable as a deduction from gross income for tax purposes, state (1) on what plant value you would base depreciation to be charged on the company's books, (2) what proportion of such depreciation you would charge against operations and (3) what proportion, if any, of such depreciation you would charge against no-par-value common stock or earned surplus, or both. Give reasons for your decisions.

No. 6 (32 points):

On December 31, 1926, A is indebted to B in the following amounts:

$1,500 due December 31, 1927, without interest;
$3,500 due December 31, 1929, with interest at the rate of 6% payable annually;
$5,000 due December 31, 1931, with interest at the rate of 6%, from December 31, 1926, not payable until maturity of note but to be compounded annually;
$6,000 due December 31, 1932, with interest at the rate of 5%, payable annually.

On this date (December 31, 1926), A learns that on December 31, 1930, he will fall heir to $20,000 and arranges with B to cancel the four notes in exchange for one note due in four years. It is then agreed that the new note shall include interest to maturity calculated at 5% compounded annually and that B shall not lose by the exchange.

What will be the amount of the new note?

Given at 5%:

| | |
|---|---|
| $v^1 = .9523810$ | $(1+i)^1 = 1.0500000$ |
| $v^2 = .9070295$ | $(1+i)^2 = 1.1025000$ |
| $v^3 = .8638376$ | $(1+i)^3 = 1.1576250$ |
| $v^5 = .7835262$ | $(1+i)^4 = 1.2155062$ |

Given at 6%:

$(1+i)^3 = 1.1910160$
$(1+i)^5 = 1.3382256$

# Public Accounting in Holland

By A. van Oss

Public accountancy in Holland dates from about 1895. Before that year the larger Dutch concerns requiring certified or audited accounts for publication mostly employed English accountants and numerous members of the bookkeeping profession supplied other local demand for administrative experts. There had been since 1883 an association called "Confidentia," whose members, although not generally called "accountants" practised as such, but not until about ten or twelve years later could it be said that Dutch accountancy began to demand recognition.

In 1895 this association together with various outside practitioners organized the Dutch Institute of Accountants with a membership of 70 that had increased to 105 in 1906. In that year about 20 of the members resigned and formed another organization, the Dutch Accountants Society, whose membership had increased to over 70 when they united again with the institute in 1918. In 1919 the combined membership had become 195 and at this date has risen to 267. Aside from the regular members there are now about 762 so-called assistants who are, however, not members and are not allowed independent practice. There are other societies of eminent standing but all of them of much smaller membership and for the purposes of this article do not call for special mention.

The institute's assistants are appointed upon the recommendation of three members and must have passed an examination in bookkeeping that in the opinion of the board qualifies for entrance. They become members only after a prescribed course of study, preferably in the institute's own classes, and after passing its examinations, but no preliminary outside practice is demanded.

The statutes of the institute contain no provisions that differ much from those of other like documents. Its purpose is (1) to organize accountancy in the Netherlands and the Dutch colonies, (2) to encourage the employment of accountants, (3) to work for legal regulation of the profession and (4) in general to promote the interests of its members and associates. The statutes further provide for the appointment of committees of discipline, rules, etc., the publication of proceedings, rules of professional conduct and practice, a bureau of examinations, the institution of study courses, the foundation and upkeep of a library and they also lay down the following inhibitory rules:

The members are forbidden:
- (a) Otherwise than by means of advertisements to call attention to their offices.
- (b) To offer services in writing or by circular, unless they are asked to do so. (Ordinary notifications of establishment, change of address or name of firm, appointment of partners and managers, as well as soliciting for business publicly offered or for appointment as auditors in case of vacancies are not forbidden.)
- (c) To do promoters' work.
- (d) To act as accountants of a business of which they are officers or directors.

The institute has also adopted specific rules covering the essential features of certificates, reports, statements and other work, the limitations of the accountant's responsibility, etc. It promotes sound professional practice and conduct and in the absence of legal regulation seeks by its own rules and standards to merit the confidence of the public and the business world in its members.

By keeping these standards high it has become more and more difficult to gain admission to membership. At the organization of the institute every one was admitted who had practised the profession for five years, but immediately thereafter the only way to become a member was by passing its examinations and these have become more and more exacting so that they now require a preliminary education and a theoretical and practical knowledge of auditing, accounting, commercial law, finance, taxation, general economics, etc., of no mean order. The institute's examination programme may be of interest.

Three different examinations have to be taken covering (1) preliminary education, (2) general commercial science and (3) accountancy.

The requirements for preliminary education include a thorough knowledge of three foreign languages—French, English and German; of arithmetic, algebra, civics, geography and history.

General commercial science includes:
- (a) Trade and credit customs—including knowledge of the principal instruments and forms used in general business.
- (b) Financial and business arithmetic.
- (c) Economic history of the Netherlands, the Dutch colonies and other countries.
- (d) Economic geography—including knowledge of sources and production of the principal raw materials and other commodities and of the important trade routes, harbors and markets all over the world.

(e) Economics—embracing general principles, the theories of value and prices, money, credit and banking, trusts and kartells, labor movements, etc.
(f) Law—including principles of civil and commercial law and the material features of all statutes that are of importance in the practice of accountancy.

Only those are admitted to the above examinations who fulfil the institute's requirements for preliminary education. Part or entire exemption is granted to holders of certificates of recognized institutions.

The examinations for accountancy can be taken only by those who have passed the above preliminary tests, so far as they were not entitled to exemption, and include:

(a) Business economics.
(b) Single and double-entry bookkeeping—including municipal bookkeeping.
(c) Statistics—including the general principles of averages, methods, forms and their applications to various types of administration.
(d) System—namely the application of various types of bookkeeping methods, budget administration, design and installation of books and records and forms of accounts, knowledge of mechanical aids.
(e) Auditing.
(f) Interpreting accounts.
(g) Writing reports.
(h) Tax laws and their application.
(i) History of accountancy and of the development of the accountant's profession.

Exemptions are given for business economics but only to holders of certificates of the higher Dutch institutions and full membership of the institute calls for the actual passing of its examination in all other subjects.

A prospectus is issued by the institute wherein the foregoing subjects and requirements are specified. There is also a list of the books that the applicant should study and this list includes the latest German, French, English and American contributions to the literature of the profession. The variety of subjects and their difficulty have not acted as deterrents to the aspiring Dutch student. As in the United States so in Holland the profession has attracted a large number of well qualified and ambitious applicants. Moreover, the demands of the public and of the business world are becoming more and more exacting, and the examinations have as a result become more and more difficult and the educational and intellectual level of the new practitioners correspondingly higher.

There is now on foot a movement to have this programme or a similar one accepted by several of the existing accountants' organizations and indications are that soon an agreement will be reached. This movement, of course, recognizes the necessity for timely changes of the programme parallel with the progress in the profession. At present it takes a graduate of a Dutch high school, while working in an accountant's or other office, about eight years to complete the required studies and to be graduated as a full member. The institute's examinations are both written and oral.

So far as theory and book knowledge are concerned the Dutch beginner, after having mastered the programme outlined can be expected to hold his own among accountants of other nationalities. The programme gives proof that a proper estimate is held within the profession of the importance of thorough preliminary groundwork. It would seem, however, that the entire absence, already mentioned, of practice requirements may somewhat reduce his otherwise great advantages, even though at the examinations of the institute the questions are usually framed to test the practical insight of the applicant.

Several Dutch practitioners are of the opinion that it would be of benefit to make a few years' professional practice an essential requisite. Many, however, believe that it would give rise to an apprentice system in some form or another which in turn would encourage monopolistic tendencies and restrict entrance into the profession to the financially privileged.

Also in Holland there has been a tendency toward combination and association and the relative number of firms as against single practitioners as well as their size has increased and still is increasing. The profession is fully aware of the advantages of this kind of organization. The ideas expressed in certain articles written on the subject show sound perceptions concerning internal organization of accountant offices, the relations between junior and senior assistant, managers and principals, the control of the work in hand, responsibilities, etc. As customary in such articles excellent methods are advocated indicative of earnest endeavor to approach a high efficiency. The writer is not personally acquainted with the internal workings and routine of Dutch accountants' offices and does not know how near the average performance approaches the set standard. From general experience he believes that the love of the Dutch for administrative detail and order prevails also here and makes them lean in the direction of methodical record.

The increased government control and taxation and the progress in banking industry and trade have also in Holland brought about an increased demand for accountants' services and for ever higher qualifications in ability and character. Many practitioners believe that legal regulation of the profession will further this tendency. They believe it is bound to come and that further postponement will only increase the difficulties to be met in the transition period.

As already mentioned the several accountants societies have in the absence of government regulation set their own standards of entrance requirements and general professional conduct. The majority of practitioners, however, seem to favor regulation by law, in the belief that opinions and interests within the profession are too diversified to deal efficiently and fully with the problem by internal rules. Some very eminent members of the profession have expressed their doubts and do not take it at all for granted that legal regulation is necessary or even of general benefit. They believe that it will give no better protection to the investing public or the business world in general and that the demand does not come from outside but almost entirely from inside the profession. On the principle that practice will on the whole go to the most competent and worthy, whether or not they have state certificates, they feel that regulation is better left to the accountants themselves.

The law already gives authority to courts of justice or special commissions to employ accountants in specific instances. Sooner or later a certification by accountants of the annual accounts of all corporations may be required. It is generally thought by those in favor of government regulation of the profession that it should precede such a compulsory measure. The extent to which the government should step in is of course a matter on which the opinions differ. It would seem that accountants generally favor regulation that is confined to the use of the designatory title and to the institution of state examinations for full membership, covering of course educational requirements, practical experience, age limit, etc. Proper legislation is expected to do away with many of the present examination boards, commissions of control, discipline, conduct, etc., and by thus simplifying conditions within the profession to eliminate the confusion that results from the diverse standards set up by the various societies.

Accountants in Holland do not believe that any accountancy law should prescribe specific rules of conduct, except perhaps concerning professional secrecy, or meddle with the accountant's responsibilities except on very broad lines, since these matters can be properly left, as they are now, to professional organizations. On the whole there seems to be a considerable majority in favor of legal regulation and the Dutch Institute of Accountants has made it one of its principal objects.

In the absence of legal regulation and consequently of its influence upon opinions and practice, the ideas concerning professional responsibility and conduct have on the whole developed on ethical and moralistic lines and as a result there is yet much diversified opinion among well-known authorities. Every society of accountants has set its own standards, to which its members have to adhere. These standards are of course developing with the increased scope and importance of the profession and probably tend toward uniformity although this state has certainly not yet been reached.

There are prominent Dutch accountants who consider that in the ordinary task of auditing accounts their clients can not limit the scope of the work to be done and that they can themselves limit it only in so far as there is proper justification. They believe that an accountant's opinion is of no value except when it can be based upon work actually performed by himself or his associates and in accordance with established theory and practice. They insist that a complete verification is necessary of the book figures, including for instance actual stock taking and valuation, a verification of debtors' balances, including circularization and a thorough investigation of the internal audit system, before an opinion can be given. They do not believe that the opinion or the certificate of responsible officers of a concern can or should take the place of their own investigation and insist that the accountant is responsible, not only for the technical correctness of the figures but also for the impression that the accounts audited by him produce on the mind of third parties.

They consequently insist that, the usual accountant's declaration being of no value if not based upon substantially unrestricted investigation, no ordinary audit work should be undertaken wherein the client limits the scope of the examination. No qualification on account of limited scope is thus thought admissible in an accountant's declaration and only such qualifications are admitted as have bearing upon the results of an investigation in which the accountant's work has not been restricted.

Many practitioners accept the above view for all cases where the result of their work will come before the public. Where it is intended only for the clients' personal or other restricted use, they believe that limited instructions may properly be carried out. Others are of the opinion that the usual restrictions upon actual stock taking, circularizations of debtors, checking the income and outgo of cash, merchandise, materials and supplies may be accepted, and in actual practice they probably constitute a large majority.

The responsibility of the accountant in Holland is the subject of many discussions and published articles. A comparison with like expressions by, say, British authorities directly discloses a dissimilarity of view. The Dutch, as already observed, occupy a strictly professional position unaffected by any regulatory laws, while the British accountants are guided by the companies act and court decisions.

The Dutch accountant takes his profession as one of very wide scope and believes that it embraces also the functions of the business economist. Through his studies of economics he feels that he can give better service as an accountant and that he is better able to collect and present the essential data that permit banker, business man and general public to draw conclusions. As long as his functions are confined to the statement of facts disclosed through examination of books and records, there is nothing unusual in this view. There is a tendency, however, perhaps stronger than in countries where the profession has been longer established, to go beyond this and to enter upon the domain of the efficiency or business expert. Some of the textbooks and other literature decidedly encourage branching out in this direction instead of advocating more conservative limitation.

The form of the accountant's certificate is a fruitful subject for discussion. Preferences of eminent practitioners vary between a simple signature and more detailed expressions of opinion, statements of work performed and qualifications. The certificates attached to the published accounts of some of the larger United States and English corporations are often quoted in these discussions. On the whole the so called "long" certificate is not looked upon with favor.

The institute's rules stipulate that the accountant's signature to any statement expresses his approval of the statement, subject only to the qualifications expressed over his signature. This rule is by many prominent members interpreted as meaning that in the certificate a statement of the work performed or omitted (for instance, in case of inventories, debtors' accounts, etc.) is not permissible, for the reason that this would virtually admit the client's right to limit the scope of the work to be done. In these circumstances they will refuse to certify. Others, however, do not take this stand and do not hesitate to mention facts of this kind in their certificates.

Although a very busy season, the first months of the year do not produce in Holland the tremendous rush of work with which the American accountants have to struggle. The bulk of the work consists of continuous audits. Annual verifications of assets and liabilities undertaken soon after the close of the calendar year are not as customary as in the United States. The problem how to tide over this period of stress is therefore not so serious and the work as a rule is handled with the regular assistants and without employing temporary help.

The Dutch accountants' offices and the work in general are organized very much like those in the United States. The usual gradation as to juniors, seniors, managers and partners exists and the supervision and personal contact between them as well as the system of promotion among them are very much the same.

The accountant's staff is recruited from graduates of business schools and colleges and from bookkeepers and other office employees who are preparing themselves for the accountant's certificate. Although there are no actual practice requirements for entrance to full membership of the Institute, the examination questions are such that considerable practical knowledge is necessary to work them out satisfactorily. It should therefore not be thought that the Dutch accountant enters the profession as a full-fledged member without having as a rule a reasonable amount of experience in technique.

The profession is not so long established in Holland as it is, for instance, in Great Britain, but Holland seems to be ahead of most other European countries. There is hardly a business of any size that has not important connections with other countries and a thorough knowledge of international exchange is required in most matters of finance, while in the period of currency inflation and gradual recovery especially difficult problems had to be solved in the effort to guard against exchange losses. Furthermore, the domestic system of purchase and sale, paying and collecting debts, banking, etc., is far from simple. Holland, although small, thus has had a relatively wide field for the development of its accountancy.

When he leaves the more advanced schools the average Dutch youth is well equipped as to foreign languages. He has usually studied German, English and French and speaks these languages quite fluently. From the beginning of his business career he absorbs an intimate knowledge of foreign exchange and becomes familiar with rather intricate general business and office methods. As soon as he commences his work as an assistant accountant he is confronted with varying problems and practice in his diverse audits. Everywhere he has to meet the problems and conditions that arise from differences in currency standards, import and export duties and regulations, taxes of all kinds in various countries, and he has to master and adapt himself to the accounting and other methods whereby these conditions are turned to advantage or their disadvantages minimized.

The assistants of the higher junior and senior grades, after passing through the selective processes, are good material and by reason of their international outlook and experience would be desirable adjuncts to the continental branch offices of British or American accountant firms. Some of these firms have already made the experiment with seemingly satisfactory results and to mutual advantage.

A word should be said concerning office and factory bookkeeping and administration in Holland. The good sized modern concerns are getting quite up to date in that respect. They seem to incline considerably toward administrative control—in my experience certainly more so than in the United States. This may find its cause in prevailing social and business conditions and it is perhaps a necessary stage in the evolution toward a high modern level. In many concerns control of capital expenditure, standard costs and budgetary methods are in successful operation and a typical Dutch administration does not suffer from lack of detail.

Nor is Holland behind in the attempt to effect economies by means of accounting appliances. Most of the machinery is of American make or type and is vigorously pushed and eagerly given a test. The old objections to loose-leaf and card ledgers are almost entirely overcome and there are several large banking and business institutions whose administrations are almost entirely mechanized. Payrolls, customers' invoices and ledgers, stock records, cost accounts and statistics are often prepared and kept by machinery and on the whole the familiar mechanical equipment of the American offices is also here in general use and in great and ever-increasing demand.

After all, the difference between American and Dutch accountants and accountancy is not very great. They probably only differ in so far as Dutchmen differ from Americans and general conditions in Holland from those in the United States.

The Dutch accountants are as a rule better versed in the theory of accountancy and related studies and therefore often inclined to look upon the practice in the light of theories absorbed. One often observes in the younger Dutch accountants a tendency to look upon accountancy more as a science and as a subject to be studied from books and lectures and less as a profession or an art that has to be learned from actual practice. This may be ascribed to the intensive, thorough-going schooling they have received from early youth to graduation from high school or college.

Dutch accountancy is more complicated because of the more involved conditions in a small, commercially long developed and centrally situated country. International trade and finance, exchange fluctuations, import duties, taxation, tradition, general customs and probably many other causes work together to make them so.

The facts given in this article are taken mostly from authoritative sources, viz.: statutes, rules and regulations of the several accountants' associations, textbooks, published lectures, etc.

I am also much indebted to several colleagues and acquaintances, all present or past members of the profession, fully acquainted with its history and much interested in its progress and achievement.

*The* JOURNAL *of* ACCOUNTANCY

*Official Organ of the* AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

# EDITORIAL

**The Del Monte Meeting**

The next annual meeting of the American Institute of Accountants is one that will almost certainly be well attended, and this for several reasons. It is to be the fortieth anniversary of the formation of the American Association of Public Accountants (predecessor of the Institute) the first organization of professional accountants having anything like a national scope. It is to be held at one of the most delightful places in America. Every American knows, if he reads advertisements at all, that he should see America first, or, if not first, at least now. The number of members and guests attending will include many of the active men of the profession and the long journey which those from the east will be required to undertake will be made in good and pleasant company. Those rare accountants who are addicted to golf will have wonderful opportunities to indulge their desires. Those who love scenery will see the best the country has to offer. Those very few to whom the question of expense is important need not hesitate—the cost of the trip is not excessive, all things considered. There are probably many other equally good reasons for going to the Del Monte meeting and the committee which has it in charge to encourage attendance will doubtless think of some of these other inducements. If, as now appears possible, the eastern members can visit on the way out the accountants of Canada, who will assemble at Winnipeg, that will not fail to attract. In a word, leaving out of consideration the importance of attending every annual meeting and participating in the business and professional fellowship there, this meeting of 1927 has an appeal that few, we hope, can resist.

**Auditors as Scapegoats for Directors**

A good deal of interest has been expressed by the press in the action of the shareholders of Marconi's Wireless Telegraph Co., Ltd., at a meeting held in London on March 15th. The meeting was characterized by a good deal of bitterness, which is perhaps not difficult to understand because the report which the directors presented to shareholders indicated that the company had to face serious capital losses. The history of the wireless company has been rather checkered and there have been times when it has been almost impossible even for the auditors to form an opinion as to the actual value of the company's assets. The present management of the corporation disclaims responsibility for investments which have not been profitable and emphasizes the fact that it has departed from the policies of its predecessors. The extraordinary feature of the meeting was the fact that in spite of the perfectly clear confession that the auditors had not in any way been responsible for the position of affairs, that in fact they had done everything that had been done to bring to light the actual conditions, the shareholders failed to accept the recommendation of the directors and to reëlect a firm of auditors which had been associated with the company for many years. The meeting then elected two firms, one of which had previously had nothing whatever to do with the company. This is so contrary to British practice that it is noteworthy. It is the general custom in Great Britain to reëlect, if the auditors are willing to be reëlected, those who have served the company year after year. The only cause which is regarded as sufficient to justify a change is failure to perform accounting services in a satisfactory manner. In this case, however, the shareholders seem to have been looking for a whipping boy and to have selected the accountants as the butt of attack. Their action seems to have been dictated by something approaching an unreasoning desire to hit someone who would not hit back. The retiring auditors, seeing the sentiment of the meeting, did the only thing that could be done and withdrew their names before election. It will be interesting to see what effect this unprecedented action of the wireless company may have on the shareholders of other corporations. The system of continuity in auditorship is so well established, however, that it does not seem probable that there will be any change in common practice. It would be most regrettable if shareholders in corporations generally should depart so radically from the principles of sound business procedure.

**This Naughty Profession**

Elsewhere in this issue of THE JOURNAL OF ACCOUNTANCY will be found a letter from Carl B. Robbins taking serious exception to a review by F. W. Thornton of a book by

Mr. Robbins entitled *No-par Stock.* When this letter was received we asked Mr. Thornton to give us a brief expression of his thoughts on the subject which the letter discusses. And thus we are able to present both sides of the question at the same time—always a desirable procedure when practicable. The task of the book reviewer is never an unalloyed and pure pleasure. There are three factors always to be borne in mind: first, of course, comes the obligation to tell the truth; second, there is the duty to the reader who may be guided or misguided by the reviewer's comments; third, the feelings of an author must be considered if that can be done without losing sight of the other factors. Few authors are satisfied that the reviewer is fair unless the review is an encomium. It is not in nature to rejoice in adverse criticism. But it is one of the penalties of authorship that the child of one's brain shall be battered about in the school of critics, and most men of letters are willing to let the infant take its chances among the rough fellows of the press. One of the least lovely of Lord Byron's failings was his sensitiveness to criticism. If he had been a good sportsman we should like him better. Now it seems to us that Mr. Robbins is somewhat unhappily offended and not altogether with good cause. Mr. Thornton was not in agreement with much that the book contained and he said so with what was perhaps a slight disregard of the third factor which we have mentioned, but surely he was and is entitled to differ with the author—the author evidently differs with Mr. Thornton. In the ordinary way we should publish this correspondence and let the reader decide for himself who had the better of the tilting. But it happens that the acerbity of the author's reply induced a little further search of the text itself. A great point is made of the distinction between innocence and ignorance and it must be admitted that when one digs up the roots of these two words there is a difference—they are not synonymous. In current practice, however, they are coming somewhat nearer together and the precession of the equinoxes will not be checked if the words are confused. A glance at the book reveals what we might have misconstrued as an attack on accountants, but we now have it on Mr. Robbins' own authority that he has the interests of the profession at heart. We find that the remarks to which the reviewer took exception were not the only instance of this apparently inimical sentiment. Turning a leaf we come to page 142 where the position of honor is given to this splendid manifestation of the cardiac propinquity of the writer's interest in the profession: "It is commonplace among the profession that balance-sheets must be designed to please the client, but too often this is accepted as final." Really, if an accountant were not the most patient of souls he might be expected to reply, "Well, well, where did you obtain this commonplace?" It would be quite wrong to treat the matter in that way, it now appears, because Mr. Robbins has disclaimed enmity and malice. There may be accountants, there are indeed, who would sway in the wind of a client's desires, especially if there were only one client—but to say that this prostration is common is ridiculous. The author could not have intended his dictum to be so interpreted. There is some occult friendliness about the words which we did not discover unaided. Perhaps the author feels that chastisement is good for the soul, if not pleasant for the body, of this rapidly growing child, accountancy, and so he lays upon us the might of his uplifted arm. He may even be saying to us, "This pains me more than you, my son." So in the long run when the soreness shall have passed away and we can again sit down in comfort we shall be all the better for the chastening. But the love which he bears the profession is possibly a little too well covered.

> "Perhaps it was right to dissemble your love—
> But why did you kick me down stairs?"

**Institute's Trial Board**

The council of the American Institute of Accountants sitting as a trial board at Washington, D. C., on Monday, April 11, 1927, heard and considered charges of discreditable conduct which had been preferred against a member of the Institute. The case involved the inclusion in a tax return of a valuation of assets made by an appraisal company. This valuation was subsequently found to be erroneous and the government had held that the accountant had been negligent in not verifying the valuation before accepting it. The accountant presented evidence that the audit had been performed by a subordinate and that in presenting the valuation the attention of the income-tax unit had been drawn to the fact that the valuation of certain alleged assets had been based upon information supplied but not verified. It appeared to the trial board that the accountant had not been guilty of negligence and, while greater care might have been taken, the circumstances did not justify a finding that the accountant had been guilty of a discreditable act. The defendant was acquitted and it was resolved that in the report of the case for publication in THE JOURNAL OF ACCOUNTANCY, as required by the by-laws of the Institute, the name of the defendant should not appear.

Responsibility for Inventory

Of certain controversies among accountants the end is not yet. For example, the old differences of opinion as to the auditor's responsibility for the physical inventories of an industrial or commercial client will not be settled while there are accountants who believe that they can do everything and others who believe that they should confine themselves to labors which they are competent to perform. Unfortunately there are many business men and an even greater percentage of bankers who would like to make the auditors responsible for the accuracy of inventory count and valuation, and it is not astonishing, therefore, that there should be a number of accountants who venture into this precarious field. Naturally there are some small concerns in which an accountant or anyone else with reasonable intelligence could count accurately and value fairly the entire stock-in-trade. In the greater number of cases, however, an accountant can not honestly accept responsibility for the taking of inventory without involving an expenditure out of all proportion to the benefits to be derived. It is undoubtedly true, however, that the auditor should have knowledge of the method of taking inventory and the basis upon which it is taken and should be satisfied that the procedure is reasonable and surrounded with proper precautions. A correspondent after reading the editorial comment which appeared in THE JOURNAL OF ACCOUNTANCY for April, 1927, writes us:

*Editor, The Journal of Accountancy*

DEAR SIR: I have read your editorial in the April, 1927, issue of THE JOURNAL OF ACCOUNTANCY and the quotation from an address by Mr. May.

I believe that an auditor should supervise and be present at inventory-taking whenever and wherever possible. Inventory-taking or being present at inventory-taking is just as practicable as verifying accounts receivable and payable by direct communication.

By careful auditing an auditor could ascertain within reason the accuracy of the accounts receivable and payable or any other asset or liability. But he wants to verify the figures with the facts, therefore the direct correspondence and other means of verification. Experienced auditors know, and have found it to be so from answers received, that there are differences and other controversies. The same applies to inventories.

I was asked by a manufacturer not to qualify my certificate as to inventories. I told him I would give an unqualified certificate providing he would allow me to be present at inventory-taking and to observe and examine certain pieces of goods used by him. The stock clerks took inventory (to which I emphatically objected) of nearly 1000 yards of silks of one number, which were made up of small pieces ranging from three-fourths to two yards each, left-overs from large bolts of silk. These remnants would scarcely bring more than 25 per cent. of original cost. Furthermore, this silk could not be used for manufacturing. I asked that these items be stricken from the inventory sheets at cost. Then again I observed during the inventory-taking quite a quantity of obsolete materials and samples. Now had I not been present at the inventory-taking I would not have known of these conditions. This inventory took a decided drop in comparison with former years.

Auditors who make it a practice wherever possible to observe and supervise inventory-taking would become in time skilled in knowing values and methods of inventory-taking and beside verifying the actual facts with book figures would be giving the public a more accurate, efficient and impartial statement.

Yours truly,

HERMAN NICHOLS.

New York, April 22, 1927.

### Auditor's Position Should be Definite

There is no doubt that an auditor who follows such a procedure as that suggested by Mr. Nichols would know more about the inventory than if he were not present when it was taken, but that does not mean that he would know enough to warrant him in assuming full responsibility for it. There would be grave danger in the uncertainty as to the additional degree of responsibility which he would assume by reason of the increased knowledge which presence at the taking of inventory might be supposed to give him. Most accountants feel that unless an auditor does so much of the actual work that he can accept full responsibility for the correctness of inventory it is far better to avoid putting himself in a position where he can be charged with an indeterminate measure of responsibility. In other words, except in those very rare instances in which the inventory can be taken by the accountant himself or his assistants it seems to be unwise that he should participate or even appear to participate and thus allow others to place upon him a burden which it is not his to bear. A few years ago there was more difference of opinion as to the responsibility for inventories than there is today. Now there is in most substantial corporations a fair system of inventory record, and, unless there is something unreasonable in the statistics given to the auditor, he may in nearly all cases accept them as accurate; but of course in his certificate he should repudiate responsibility for the inventories if there is the slightest danger that any one will attribute such responsibility to him in the absence of disclaimer.

Louise S. Miltimore

The *Bulletin* of the Institute published on May 16th contained announcement of the death of Louise S. Miltimore, librarian of the American Institute of Accountants. This announcement will bring a sense of loss to all accountants and also to the far-spread fraternity of librarians. Shortly after the Institute was formed an endowment fund was created under which there was built up a library which is certainly the most extensive collection of accounting works in this country—possibly it is not excelled abroad. Miss Miltimore was in charge of the constructive work and under her direction, with approval of the special committee on administration of endowment, the Institute acquired by gift and purchase the reference and other works which have served so useful a purpose to members of the Institute and to many students and accountants who are not members. A monumental work, the *Accountants' Index* and its *Supplement* were edited entirely by Miss Miltimore, and this accomplishment alone would entitle her to a place of honor in the annals of American accountancy. An infinite number of questions upon accounting and related subjects passes through the library every year and it is very largely to the directive ability of the librarian that the success of this exchange of opinions is due. Miss Miltimore loved her work and gave without stint of her time and talents even at the expense of health. It was impossible to induce her to relinquish her activities, even for a vacation, for her enthusiasm was such that she took no count of the length of the business day. Her death followed an illness of several months. We extend to her family sincere expressions of grief and sympathy.

Natural Business Year

The annual meetings of the Chamber of Commerce of the United States of America are growing in importance and in numerical attendance. It seems that the business men of the country are looking more and more to the national chamber of commerce as the agency through which they can bring to the attention of government and public the questions which they consider vital to the country's prosperity. At the last meeting, which was held in Washington during the first week in May, there were several important resolutions calling for simplification and other reform of the federal tax laws. These resolutions were accepted and passed unanimously, and it is hoped that their effect upon the congressional investigating committee will be conclusive. But this great chamber of commerce, which is pledged to the progress of business and all that makes for the advancement of America, occasionally relapses into incomprehensible conservatism. For example, at the recent meeting there was brought forward by the Chicago Association of Commerce a resolution to the effect that the chamber should go on record as encouraging the adoption of the natural business year in all businesses which have an ebb of activity that makes one period more suitable than any other in the year for the closing of books. The Chicago resolution called for a survey of the principal industries of the country preparatory to the presentation of a definite programme to convert business men from the unnatural adoption of December 31st as the closing time. The peculiar reluctance of business men to change their fiscal years to coincide with their individual business exigencies does not seem American. When the excise tax was enacted in 1909 many companies which had followed the natural business year changed over to the calendar year in order to conform to the requirements of the law, but when, in a subsequent enactment, the permission to adopt a natural year was granted most of them failed to take advantage of the opportunity to simplify their labors. One of the reasons which seems to have interfered largely with the general adoption of the change which has been urged time and again by accountants is that some people believe that the accountants themselves have some dark ulterior motive in supporting the movement for reform. It is true that accountants would benefit enormously by spreading their work over the twelve months, but business men would profit equally and the government taxing departments, both federal and state, would be assisted and their labors accelerated. That accountants would benefit incidentally does not seem a very sound reason for objecting to reform. This resolution when brought before the resolutions committee of the chamber of commerce was referred to the directors without recommendation, which is probably a polite and effective way of putting the resolution to death.

One can not help wondering why the Chamber of Commerce of the United States of America, which embraces in its membership many of the most progressive business men, should have failed to take action on so important a matter. Perhaps the Chicago Association of Commerce will return to the attack next year, and if so it is to be hoped that the sponsors will meet with the success which their effort deserves. So far no one has been able to adduce any good and sufficient reason for adhering to the present ridiculous perversion of the business year.

**Accountants and Bankers**

The Northern Ohio chapter of the American Institute of Accountants and the Cleveland chapter of the Robert Morris Associates held a joint meeting in Cleveland on April 25th, when each one told the other frankly of his short-comings. There was the utmost good fellowship and there was a lack of that air of superiority and condescension which sometimes has interfered with progress. One of the hopeful results of the meeting was the decision to hold each year at least two joint meetings when there will be discussion of questions arising upon the accountant's reports or the banker's methods. This is a local development of the national effort which has been extremely productive in bringing about a better understanding between the bankers represented by the Robert Morris Associates and accountants represented by the American Institute of Accountants. There is really very little difference in the ideals which both classes of men hold, but there is an astonishing readiness in each class to blame the other for the things which it has failed to do. The banker would like to be able to place all responsibility for a bad credit risk upon the accountant and the accountant would like to replace the burden with interest upon the banker's shoulders—at least it is so in many cases. It is obviously absurd for the banker or the accountant to say that because the other is a party to the negotiations for credit extension he himself is relieved of all obligation to satisfy himself of the correctness of financial reports. If the two closely related professions can walk and talk together there should be complete understanding, and they will arrive together at the journey's end, which is in the delectable mountains of honest and continuing coöperation.

# Income-tax Department

EDITED BY STEPHEN G. RUSK

> "Demurrer to petition sustained, the plaintiff having failed to show that the commissioner acted arbitrarily in computing invested capital under section 207 of the 1917 act."

The decision, above quoted, in the case of *The Feilbach Company* v. *Frank B. Niles, collector*, was rendered by the United States district court, N. D., Ohio, W. D., and the quoted somewhat vague language involves an interpretation of section 210, which is interesting in that it is contrary to the generally accepted interpretation of the language of that section. This section, it will be remembered, was the one that provided for the determination of the amount of excess profits in cases where the invested capital could not be determined. In such cases the amount of the deduction (7% or 9% of invested capital) "shall be" the same as the proportion of the average deduction of representative corporations engaged in a like or similar trade or business.

The foregoing is not a literal quotation, but conveys the idea with fair accuracy.

The language of section 210 will probably stand as a model of ambiguity, but after careful analysis, almost everyone concerned reached the conclusion that its intention was to relieve certain taxpayers from an abnormally high excess-profits tax, where, for various reasons, the invested capital could not be determined.

The judge in this decision states it as his opinion that:

> "The section under consideration, 210, is one whose provisions are to be invoked primarily and most generally by the commissioner alone. Very, very rarely, and under quite extraordinary circumstances, it would seem, can the action be resorted to as a mode of relief by the taxpayer. The statute limits resort to it, too, only when the commissioner finds that he cannot 'satisfactorily' ascertain invested capital for the computation of excess-profits tax under section 207. It would follow that, if the commissioner or his agents actually computes capital under section 207, his action should be presumed to exclude any application of section 210, the burden then being upon the claimant to relief under the provisions of the latter section to show that the commissioner acted arbitrarily and without justification. It would be a rare case indeed wherein a court would be justified in concluding that the commissioner could not 'satisfactorily' apply the provisions of section 207 . . ."

We believe we are not different from most of those having contact with the acts and opinions of the commissioner, in our disbelief that congress intended that the provisions of section 210 "are to be invoked primarily and most generally by the commissioner alone." Having had many experiences wherein the commissioner, through his subordinates, has made some strange decisions in "satisfactorily" determining invested capital under the provisions of section 207, where no abnormal conditions were present, we believe that it was never intended that the commissioner's satisfaction with his computation of invested capital precluded a dissatisfied taxpayer from invoking the provisions of section 210.

We know that at the time the act of 1917 was made law, section 210 was regarded as a relief measure to be invoked by such taxpayers as would have been placed at a serious disadvantage in the payment of excess-profits taxes out of all proportion to amounts paid by those engaged in a like or similar business. We know, too, that it was not rarely, nor in extraordinary cases, that many taxpayers invoked section 210, and with success, when their taxes computed under section 210 were abnormally high. We believe the word "satisfactorily" did not imply that the computation if satisfactory to the commissioner must necessarily be final.

In view of the foregoing reasons and many others, which will undoubtedly occur to our readers, we find ourselves heartily disagreeing with the opinion of the court. As to the decision in the case under review, we have no knowledge of the facts and merits. It is only with his interpretation of the meaning of the language of section 210 that we are in disaccord.

## SUMMARY OF RECENT RULINGS

Distraint is a "proceeding" and collection thereby of income tax for 1917 is barred by section 250 (d) of the 1921 act five years from the time the return was filed, and taxpayer may recover payments so enforced. (United States district court of Massachusetts, *Ehrlich et al., Excrs.*, v. *Nichols, collector.*)

A trust created was held "intended to take effect in possession or enjoyment" at or after settlor's death, when by its terms the settlor reserved a qualified right to alter, amend or terminate the trust. (United States district court of Massachusetts, *Hill, Excr.* v. *Nichols, collector.*)

The loss from sale in 1920 of property originally acquired for residential purposes, which, from the time the owner abandoned it as his residence prior to March 1, 1913, until the sale was used for renting purposes, in the nature of a business venture, should be allowed in computing net income. (Circuit court of appeals, third circuit, *Co-executors of Philander C. Knox*, v. *Heiner, collector.*)

Section 280 of the 1926 act, which provides that the commissioner, in the same manner as in a case of a deficiency in a tax, shall determine, assess and collect the liability at law and in equity of a transferee of property of a taxpayer for a tax imposed upon the taxpayer, was held unconstitutional, as a denial of due process of law, and as violative of the constitutional provisions vesting judicial powers only to the courts.

An injunction will lie to enjoin the collection by distraint of taxes assessed against a transferee of property of a taxpayer, as the liability, if any, of such transferee is not a tax within the meaning of section 3224 of the revised statutes. (United States district court, W. D. Kentucky, *Owensboro Ditcher and Grader Co.* v. *Lucas, collector.*)

Invested capital may not be reduced by arbitrary adjustments of depreciation for prior years where the evidence did not establish that depreciation actually sustained was not charged off. (United States district court, W. D. Pennsylvania, *Maugh & Keenan Storage & Transfer Co.*, v. *Heiner, collector.*)

Cost or statutory basis of real estate should be adjusted for depreciation sustained in computing gain or loss from the sale thereof, under the 1918 and 1921 acts.

Premiums paid by the insured on life insurance policies payable to his estate, taken out and assigned to a creditor at its request as collateral for a loan, are not deductible under the 1918 and 1921 acts, from gross income of the insured, since he is directly or indirectly a beneficiary under the policy. (United States district court, W. D. Pennsylvania, *Edward E. Reick* v. *Heiner, collector.*)

No taxable income was realized upon sale or exchange of properties under the acts of 1916 and 1917, where that received in the exchange had no actual market value. (United States district court, N. D. California, S. D., *William B. Bourn*, v. *John P. McLaughlin, collector.*)

Where the actual of an equitable life estate is determinable from definite facts known at the time of the computation of the tax, mortuary tables based on probabilities may not be used to ascertain the value of such future interest. (United States district court of Massachusetts, *Boston Safe Deposit & Trust Co.* v. *Nichols, collector.*)

# Students' Department

H. A. Finney, *Editor*

H. P. Baumann, *Associate Editor*

(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.*)

*Editor, Students' Department.*

Sir: The enclosed problem was given by the Ohio State Board of Accountancy on October 13, 1926.

It would be greatly appreciated by a number of the candidates who sat at the examination, if you would publish a solution to the problem in The Journal of Accountancy and comment on the points involved and the time limit.

Yours truly,

H. J. Brown.

Columbus, Ohio

*Problem:*

A manufacturing company has an agreement with a sales company which provides that the latter company is to handle the entire output of the former company, and that the gross profits on sales are to be divided between the respective companies on the basis of 30% for the manufacturing company and 70% for the sales company. The term gross profit is to be taken as meaning the amount remaining after deducting from the net sales the actual cost of goods sold, plus 10%, and freight paid on same by the sales company. It is understood that the cost of goods shall include, in addition to the usual manufacturing charges, expenses of the cost department, shipping expenses, one-third of the salaries of the general officers, 85% of taxes, and 6% interest on $356,000 of invested capital.

Goods are to be shipped to the sales company on consignment at an estimated cost plus 10% and the consignee is to advance 75% of the billed value, which is to be paid on receipt of goods. And at the end of each month, the sales company is to remit for the balance due, at the billed value, on goods sold.

At the end of the year, adjustment is to be made of the difference between the estimated cost plus 10% and the actual cost plus 10%, if any.

The trial balance of the manufacturing company at December 31, 1925, was as follows:

| | Debits | Credits |
|---|---|---|
| Cash | $74,906.24 | |
| Sales company | 59,702.50 | |
| Raw materials purchased | 425,714.50 | |
| Productive labor | 261,000.00 | |
| Non-productive labor | 63,574.53 | |
| Cost department expense | 19,450.60 | |
| Superintendence | 15,000.00 | |
| Repairs to machinery | 19,711.65 | |
| Factory supplies and expense | 15,037.75 | |
| Interest | 4,500.00 | |
| Shipping expenses | 14,540.00 | |
| General officers' salaries | 45,000.00 | |
| Clerical salaries—general | 21,500.00 | |

| | Debits | Credits |
|---|---|---|
| General office expense.............. | $14,781.78 | |
| Machinery........................ | 200,000.00 | |
| Factory fixtures.................. | 15,000.00 | |
| Tools............................ | 20,000.00 | |
| General office fixtures.............. | 10,000.00 | |
| Land............................ | 21,000.00 | |
| Buildings (factory)................ | 100,000.00 | |
| Taxes (local)...................... | 3,500.00 | |
| Capital stock..................... | | $500,000.00 |
| Accounts payable.................. | | 65,719.55 |
| Notes payable..................... | | 75,000.00 |
| Shipments on consignment.......... | | 783,200.00 |
| | $1,423,919.55 | $1,423,919.55 |

Inventories at the end of the year were as follows:

| | |
|---|---|
| Raw materials .................................. | $58,640.50 |
| Goods in process................................ | 100,074.00 |
| Factory supplies................................ | 3,674.53 |

The goods in process included $45,815.25 for material, $30,143.75 for productive labor and $24,115.00 for overhead.

Depreciation at the rate of 10% on machinery, tools, general office fixtures, factory fixtures and 3% on buildings, is to be taken into account.

Accruals not taken into account were: $6,000 for productive labor, $2,000 for non-productive labor, $2,500 for local taxes, and $1,500 for interest on notes payable.

The net sales as reported by the consignee amounted to $1,032,240 and the total freight paid on all goods received was $15,554.61, and the value of goods on hand at original billing was $68,794.

Remittances by the consignee included the full value, at original billed price, of goods sold.

You are to submit the following:

1. A balance-sheet, after taking into account the transactions reported by the consignee. This sheet must show clearly the true financial condition of the manufacturing company, in so far as it can be determined from the given data.
2. A profit-and-loss statement, which must show the result before and after giving effect to sales by consignee.
3. Statement showing actual amount due and payable by consignee at December 31, 1925. You must show clearly how the result has been arrived at. This statement must also show the profit on sales of consignee, and how arrived at.
4. A work sheet, which must be in good form, neat and intelligible.

*Solution:*

Considering, first, the factors entering into the amount due from sales company, $59,702.50, an unaccounted-for difference of $42,504 appears as shown in the following:

| | |
|---|---|
| Charges to sales company (contra to credits, "shipments on consignment")............................... | $783,200.00 |
| Less—balance in sales company's account............. | 59,702.50 |
| Remittances received from sales company............. | $723,497.50 |

| | | |
|---|---|---|
| Representing: | | |
| 75% of billed price of $68,794.00 merchandise on hand at sales company | | $51,595.50 |
| 100% of billed price of goods sold | | $671,902.00 |
| Charges to sales company | | $783,200.00 |
| Deduct: | | |
| Goods sold (as shown above) | $671,902.00 | |
| Goods on hand | 68,794.00 | |
| Total amount of goods received by sales company (at billed price) | | 740,696.00 |
| Billed price of goods in transit | | $42,504.00 |

From the above computations, it is a reasonable assumption that the balance of the sales-company account represents:

| | |
|---|---|
| 25% of billed price of goods on hand ($68,794.00) | $17,198.50 |
| 100% of billed price of goods in transit ($42,504.00) | 42,504.00 |
| Total | $59,702.50 |

By reference to exhibit "C," it will be noted that the overhead rates for actual cost and cost by the terms of contract are 72% and 80% respectively of productive labor, the difference being due to the exclusion of interest on invested capital in determining actual cost. The reasons for excluding such interest from manufacturing cost are, it is believed, sufficiently familiar to make unnecessary extended comment thereon.

While, of course, the terms of the agreement between the manufacturing company and the sales company do not determine which items should and which should not be included in actual cost of goods manufactured, it seems that interest on invested capital is the only item as to which actual cost and agreed cost should differ. The inclusion of one-third of general officers' salaries seems a reasonable charge for the services which such officers must certainly give to manufacturing operations. Cost department expenses constitute a legitimate part of manufacturing cost, and 85% of taxes appears entirely reasonable as the proportion applicable to goods manufactured. The inclusion of shipping expenses might be debatable. However, they are, in this case, necessary expenses incurred by the manufacturing company in placing its goods in readiness for sale, and are not, as is usually the case, expenses incurred after or in connection with the sale.

Before the agreed gross profit can be determined, it will be necessary to compute that portion of the freight paid by the sales company on all goods received applicable to the goods sold. This may be done as follows:

$$\frac{\text{(Billed price of goods sold) \$671,902}}{\text{(Billed price of goods received) \$740,696}} \times \text{(Freight Paid) \$15,554.61}$$

$= \$14,109.95$ (Freight applicable to goods sold).

MANUFACTURING COMPANY

Statement showing amount due and payable by consignee
December 31, 1925

| | | | |
|---|---|---|---|
| Billed price of goods sold—as adjusted | | | $705,497.10 |
| Manufacturing company's share of gross profit: | | | |
| Sales by consignee | | $1,032,240.00 | |
| Deduct: | | | |
| Cost of goods sold (determined per agreement) plus 10% thereof | $705,497.10 | | |
| Freight applicable to goods sold | 14,109.95 | | |
| | | 719,607.05 | |
| Gross profit on sales by consignee | | $312,632.95 | |
| Deduct: | | | |
| Sales company's proportion of gross profit (70%) | | 218,843.06 | |
| | | | 93,789.89 |
| Total amount payable by consignee per terms of agreement | | | $799,286.99 |
| Deduct: | | | |
| Payments made by consignee: | | | |
| Charges to sales company | | $783,200.00 | |
| Less: present balance of account | | 59,702.50 | |
| Remittances from sales company | | $723,497.50 | |
| Deduct: | | | |
| Advances on unsold goods (75% of $68,794.00) | | 51,595.50 | |
| | | | 671,902.00 |
| Balance—representing amount due and payable by consignee at December 31, 1925 | | | $127,384.99 |

The sales company is not required to pay for any goods consigned to it until the goods are sold. The advances remitted, $51,595.50 should therefore be deducted from the remittances received and be shown as advances in the current liability section of the balance-sheet. In addition, the sales company may be required to advance 75% of the excess of the adjusted billed price over the original billed price of unsold goods, or 75% of ($72,233.70—$68,794.00) or $2,579.78, depending upon what interpretation is placed upon the third paragraph of the problem. If the sales company is required to advance this amount, a footnote covering the requirement should appear on the balance-sheet.

No advance appears to be required on the goods in transit until the sales company is in receipt of goods.

With respect to the profit-and-loss statement, it is not clear as to what is meant by the requirement that it "must show the result before and after giving effect to sales by consignee." Inasmuch as goods are shipped to the sales company on consignment no sales take place at that time, and, since it is a basic principle of accounting that profits can only be made by actual sales, it is difficult to see how a profit-and-loss statement can be prepared to "show the result" before giving effect to sales by the consignee. However, no other interpretation suggests itself to the editors than that this requirement contemplates the showing of consignments as sales (at adjusted billing price) of the manufacturing company. Accordingly, they are so shown in exhibit "B" in order to meet the requirements of the problem.

MANUFACTURING COMPANY

Adjusting Entries December 31, 1925

| | | | |
|---|---|---|---|
| (A) | Depreciation: | | |
| | Machinery (10%) | $20,000.00 | |
| | Tools (10%) | 2,000.00 | |
| | General office fixtures (10%) | 1,000.00 | |
| | Factory fixtures (10%) | 1,500.00 | |
| | Buildings ( 3%) | 3,000.00 | |
| | Reserve for depreciation: | | |
| | Machinery | | $20,000.00 |
| | Tools | | 2,000.00 |
| | General office fixtures | | 1,000.00 |
| | Factory fixtures | | 1,500.00 |
| | Buildings | | 3,000.00 |
| | To record depreciation for the year 1925. | | |
| (B) | Productive labor | $6,000.00 | |
| | Non-productive labor | 2,000.00 | |
| | Accrued wages | | 8,000.00 |
| | To set up accrued wages. | | |
| (C) | Taxes local | 2,500.00 | |
| | Accrued local taxes | | 2,500.00 |
| | To set up accrued local taxes. | | |
| (D) | Interest | 1,500.00 | |
| | Accrued interest on notes payable | | 1,500.00 |
| | To set up accrued interest on notes payable. | | |
| (E) | Merchandise consigned | 783,200.00 | |
| | Sales company | | 783,200.00 |
| | To transfer charge from sales-company account to a memorandum account. | | |
| (F) | Merchandise consigned | 39,160.00 | |
| | Shipments on consignment | | 39,160.00 |
| | To adjust memorandum accounts to 110% of cost as defined by contracts. | | |

MANUFACTURING COMPANY

Working papers for the year ended December 31, 1925

| | Trial balance December 31, 1925 | | Adjustments | | Cost of consigned goods sold | | Profit and loss | | Balance-sheet | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. | Dr. | Cr. |
| Cash | $74,906.24 | | | | | | | | $74,906.24 | |
| Sales company | 59,702.50 | | $799,286.99 (H) | $783,200.00 (E) | | | | | | |
| | | | 51,595.50 (J) | | | | | | 127,384.99 | |
| Raw materials purchased | 425,714.50 | | | | $367,074.00 | | | | 58,640.50 | |
| Productive labor | 261,000.00 | | 6,000.00 (B) | | 267,000.00 | | | | | |
| Non-productive labor | 63,574.53 | | 2,000.00 (B) | | 65,574.53 | | | | | |
| Cost department expense | 19,450.60 | | | | 19,450.60 | | | | | |
| Superintendence | 15,000.00 | | | | 15,000.00 | | | | | |
| Repairs to machinery | 19,711.65 | | | | 19,711.65 | | | | | |
| Factory supplies and expense | 15,037.75 | | | | 11,363.22 | | | | 3,674.53 | |
| Interest | 4,500.00 | | 1,500.00 (D) | | | | $6,000.00 | | | |
| Shipping expenses | 14,540.00 | | | | 14,540.00 | | | | | |
| General officers' salaries | 45,000.00 | | | | 15,000.00 | | 30,000.00 | | | |
| Clerical salaries—general | 21,500.00 | | | | | | 21,500.00 | | | |
| General office expense | 14,781.78 | | | | | | 14,781.78 | | | |
| Machinery | 200,000.00 | | | | | | | | 200,000.00 | |
| Factory fixtures | 15,000.00 | | | | | | | | 15,000.00 | |
| Tools | 20,000.00 | | | | | | | | 20,000.00 | |
| General office fixtures | 10,000.00 | | | | | | | | 10,000.00 | |
| Land | 21,000.00 | | | | | | | | 21,000.00 | |
| Buildings—factory | 100,000.00 | | | | | | | | 100,000.00 | |
| Taxes—local | 3,500.00 | | 2,500.00 (C) | | 5,100.00 | | 900.00 | | | |
| Capital stock | | $500,000.00 | | | | | | | | $500,000.00 |
| Accounts payable | | 65,719.55 | | | | | | | | 65,719.55 |
| Notes payable | | 75,000.00 | | | | | | | | 75,000.00 |
| Shipments on consignment | | 783,200.00 | 705,497.10 (G) | 39,160.00 (F) | | | | | | 116,862.90 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Depreciation—machinery | | | $20,000.00 (A) | | $20,000.00 | | | | | |
| Depreciation—tools | | | 2,000.00 (A) | | 2,000.00 | | | | | |
| Depreciation—general office fixtures | | | 1,000.00 (A) | | | | $1,000.00 | | | |
| Depreciation—factory fixtures | | | 1,500.00 (A) | | 1,500.00 | | | | | |
| Depreciation—buildings | | | 3,000.00 (A) | | 3,000.00 | | | | | |
| Reserve for depreciation | | | | $27,500.00 (A) | | | | | | $27,500.00 |
| Accrued wages | | | | 8,000.00 (B) | | | | | | 8,000.00 |
| Accrued taxes | | | | 2,500.00 (C) | | | | | | 2,500.00 |
| Accrued interest | | | | 1,500.00 (D) | | | | | | 1,500.00 |
| Goods in process | | | | | | $97,662.50 | | | $97,662.50 | |
| Merchandise consigned | | | 783,200.00 (E) | | | | | | | |
| | | | 39,160.00 (F) | 705,497.10 (G) | | | | | 116,862.90 | |
| Sales | | | | 799,286.99 (H) | | | | $799,286.99 | | |
| Advances from sale company | | | | 51,595.50 (J) | | | | | | 51,595.50 |
| Cost of goods unsold | | | | | | 103,546.29 | | | 103,546.29 | |
| Cost of goods sold | | | | | | 625,105.21 | 625,105.21 | | | |
| Net profit | | | | | | | 100,000.00 | | | 100,000.00 |
| | $1,423,919.55 | $1,423,919.55 | $2,418,239.59 | $2,418,239.59 | $826,314.00 | $826,314.00 | $799,286.99 | $799,286.99 | $948,677.95 | $948,677.95 |

| | | | |
|---|---|---|---|
| (G) Shipments on consignment | | $705,497.10 | |
| Merchandise consigned | | | $705,497.10 |
| To adjust memorandum accounts to billed price of goods unsold: | | | |
| Original billed price of shipments | $783,200.00 | | |
| Adjustment above | 39,160.00 | | |
| Total | $822,360.00 | | |
| Less—adjusted billed price of goods sold | 705,497.10 | | |
| Adjusted billed price of goods unsold | $116,862.90 | | |
| (H) Sales company | | 799,286.99 | |
| Sales | | | 799,286.99 |
| Adjusted billed price of goods sold | $705,497.10 | | |
| Share of profit | 93,789.89 | | |
| Total | $799,286.99 | | |
| (J) Sales company | | 51,595.50 | |
| Advances from sales company | | | 51,595.50 |
| To record as a liability advances received from sales company, 75% of billed price of goods on hand, $68,794.00. | | | |

*Exhibit "A"*

MANUFACTURING COMPANY

Balance-sheet December 31, 1925

*Assets*

| | | | | |
|---|---|---|---|---|
| Current assets: | | | | |
| Cash | | | $74,906.24 | |
| Due from sales company | | | 127,384.99 | |
| Inventories: | | | | |
| Raw materials | | $58,640.50 | | |
| Work-in-process | | 97,662.50 | | |
| Finished goods on consignment | | 103,546.29 | | |
| Supplies | | 3,674.53 | 263,523.82 | $465,815.05 |
| Capital assets: | Cost | Depreciation Reserve | Book Value | |
| Land | $21,000.00 | ........ | $21,000.00 | |
| Buildings | 100,000.00 | $3,000.00 | 97,000.00 | |
| Machinery | 200,000.00 | 20,000.00 | 180,000.00 | |
| Factory fixtures | 15,000.00 | 1,500.00 | 13,500.00 | |
| Tools | 20,000.00 | 2,000.00 | 18,000.00 | |
| General office fixtures | 10,000.00 | 1,000.00 | 9,000.00 | |
| | $366,000.00 | $27,500.00 | $338,500.00 | 338,500.00 |
| | | | | $804,315.05 |

*Liabilities and net worth*

| | | | |
|---|---|---|---|
| Current liabilities: | | | |
| Accrued local taxes | | $2,500.00 | |
| Accrued wages | | 8,000.00 | |
| Accounts payable | | 65,719.55 | |
| Notes payable | $75,000.00 | | |
| Accrued interest on notes payable | 1,500.00 | 76,500.00 | |
| Advances from sales company | | 51,595.50 | $204,315.05 |
| Net worth: | | | |
| Capital stock | | $500,000.00 | |
| Surplus net profits for the year Ended December 31, 1925 (exhibit "B") * | | 100,000.00 | 600,000.00 |
| | | | $804,315.05 |

* Subject to federal income taxes for the year 1925.

*Exhibit "B"*

MANUFACTURING COMPANY

Statement of profit and loss for the year ended December 31, 1925

| | Before giving effect to sales by consignee | After giving effect to sales by consignee |
|---|---|---|
| Consigned sales | $705,497.10 | $799,286.99 |
| Cost of consigned goods sold | 625,105.21 | 625,105.21 |
| Gross profit | $80,391.89 | $174,181.78 |
| Expenses: | | |
| General officers' salaries | $30,000.00 | $30,000.00 |
| Clerical salaries—general | 21,500.00 | 21,500.00 |
| General office expense | 14,781.78 | 14,781.78 |
| Taxes—local | 900.00 | 900.00 |
| Depreciation—general office fixtures | 1,000.00 | 1,000.00 |
| Total | $68,181.78 | $68,181.78 |
| Profit from operations | $12,210.11 | $106,000.00 |
| Interest paid | 6,000.00 | 6,000.00 |
| Net profit to surplus (subject to federal income taxes) | $6,210.11 | $100,000.00 |

*Exhibit "C"*

MANUFACTURING COMPANY

Statement showing cost of goods manufactured and consigned for the year ended December 31, 1925

| | Actual cost | Cost per terms of contract and adjusted billing price |
|---|---|---|
| Raw materials | $367,074.00 | $367,074.00 |
| Productive labor | $267,000.00 | $267,000.00 |

| | | |
|---|---|---|
| Overhead: | | |
| Non-productive labor | $65,574.53 | $65,574.53 |
| Cost department expense | 19,450.60 | 19,450.60 |
| Superintendence | 15,000.00 | 15,000.00 |
| Repairs to machinery | 19,711.65 | 19,711.65 |
| Factory supplies and expenses | 11,363.22 | 11,363.22 |
| Shipping expenses | 14,540.00 | 14,540.00 |
| General officers' salaries | 15,000.00 | 15,000.00 |
| Taxes | 5,100.00 | 5,100.00 |
| Depreciation: | | |
| Machinery | 20,000.00 | 20,000.00 |
| Tools | 2,000.00 | 2,000.00 |
| Factory fixtures | 1,500.00 | 1,500.00 |
| Buildings | 3,000.00 | 3,000.00 |
| Interest—6% of $356,000 | ....... | 21,360.00 |
| Total overhead | $192,240.00 | $213,600.00 |
| Ratio of overhead to productive labor | (72%) | (80%) |
| Total raw materials, productive labor and overhead | $826,314.00 | $847,674.00 |
| Deduct inventory of goods-in-process, December 31, 1925: | | |
| Materials | $45,815.25 | $45,815.25 |
| Productive labor | 30,143.75 | 30,143.75 |
| Overhead: | | |
| 72% of $30,143.75 | 21,703.50 | |
| 80% of $30,143.75 | | 24,115.00 |
| Total goods-in-process | $97,662.50 | $100,074.00 |
| Cost of goods manufactured and consigned | $728,651.50 | $747,600.00 |
| Add: | | |
| Agreed percentage (10%) | | 74,760.00 |
| Adjusted billing price | | $822,360.00 |

Apportionment of costs:

| | In ratio of original billed price | Actual cost | Adjusted billed price |
|---|---|---|---|
| Goods in inventory | $68,794.00 | $64,002.62 | $72,233.70 |
| Goods in transit | 42,504.00 | 39,543.67 | 44,629,20 |
| Total unsold | $111,298.00 | $103,546.29 | $116,862.90 |
| Goods sold | 671,902.00 | 625,105.21 | 705,497.10 |
| Total | $783,200.00 | $728,651.50 | $822,360.00 |

*Editor, Students' Department,*

SIR: In the *Students' Department* of the April number of THE JOURNAL is printed an answer to one of the questions in the last Institute examination, which calls for the preparation of a financial statement of Snow, Frost & Co., stock brokers. This answer does not, and possibly was not intended to cover all the points raised in the question.

Either by intention of the examiners or otherwise a full answer could only be expected from candidates who were acquainted with the questionnaires which are periodically sent, by the committee on business conduct, to members of the New York stock exchange. But aside from this, any adequate answer requires a working knowledge of the stock brokers' business and the implications arising therefrom.

The legal theory as at present developed, which applies to a stock broker's dealings with his customers, appears to be that he is merely the custodian of the securities which he is carrying on margin for their account. The securities are held to be the actual property of the customers subject to the stock broker's claim for the unpaid portion of the purchase price. The debit ledger balances of fully secured customers are not therefore liabilities of such customers to the broker. On the contrary, the equities of such customers in the securities carried for their account are liabilities of the broker to those customers. As a consequence, in preparing a financial statement, the accounts appearing on the debit side of the ledger are, in large part, transformed into liabilities; the accounts appearing on the credit side are, in large part, transformed into assets; and the value of the securities in box or transfer, which does not appear on the ledger at all, is set up as an asset.

The attached statement A is a financial statement in the form called for and statement B, the working-sheet from which statement A is prepared, is patterned on an answer to a New York stock exchange questionnaire.

There are two points in the question which call for attention. (1) It is questionable whether or not the examiners expect the two items "customers unsecured $2,500" and "advances to salesmen $750" to be charged off. The stock exchange committee's accountants would allow no value for these items, but in a statement for general purposes it would be rather drastic to charge them off without certain knowledge that they were worthless. (2) Under item 7 of the explanatory matter the examiners state that included in the bank collateral are $5,000 of securities held in what is known in brokerage circles as "safekeeping." This is an infraction of the stock exchange rule which requires that all securities paid for in full by customers be kept in the "box." There appears no good reason, however, to differentiate these securities in a financial statement issued for general purposes, unless by means of a footnote. The bank loans would still be secured by a margin of over 20% if the small amount of securities in "safekeeping" were withdrawn from the collateral.

The firm's capital in statement A appears as $486,250. The stock exchange committee's accountants would reduce this figure. Although it is, of course, impossible to speak with any certainty, they would probably scale it down somewhat as follows:

| | | |
|---|---|---|
| Firm capital | | $390,750.00 |
| Equity in securities account | | 95,500.00 |
| | | $486,250.00 |
| Deduct: | | |
| Memberships | $90,000.00 | |
| Customers unsecured | 2,500.00 | |
| Advances to salesmen | 750.00 | |
| Margin on firm-trading account | 60,000.00 | |
| Margin deficiency on partly secured customers' accounts | 18,000.00 | 171,250.00 |
| Effective capital | | $315,000.00 |

The effective capital is ample for the amount of business carried, being nearly 24% of the fully secured customers' balances. Exception must be taken to the fact that all of the capital was locked up in the ledger item "securities $400,000." If these securities were liberty bonds or other gilt-edged paper this objection would amount to little. If they were speculative stocks the account should be reduced; if not closed out entirely. The small amount of securities in the box might cause adverse comment. The stock exchange rule on securities in safekeeping also applies to securities carried for customers whose accounts are extra-heavily margined. The long customers' equities are nearly 34% of their debit balances. It is quite possible that the margin percentage in some cases runs up considerably higher. The question might then arise as to whether the securities in the box were sufficient to cover the excess margins.

*Statement A*

SNOW, FROST AND COMPANY

Financial Statement—June 30, 1926

*Assets*

| | | | |
|---|---|---|---|
| Cash | | | $75,000.00 |
| Firm's equity in securities hypothecated: | | | |
| Market value of bank collateral | $185,000.00 | | |
| *Less:* bank loans | 145,000.00 | | |
| Equity | | $40,000.00 | |
| Market value of broker's collateral | $1,955,000.00 | | |
| *Less:* broker's balances | 1,400,000.00 | | |
| Equity | | 555,000.00 | |
| | | | 595,000.00 |
| Market value of securities in box or transfer | | | 191,000.00 |
| Accounts receivable: | | | |
| Customers' partly secured long-ledger balances, Debit | $110,000.00 | | |
| Market value of securities | 90,000.00 | | |
| | | $20,000.00 | |
| Customers' partly secured short-market value of securities | $9,000.00 | | |
| Ledger balances, Credit | 7,500.00 | | |
| | | 1,500.00 | |
| Customers' unsecured | $2,500.00 | | |
| Advances to salesmen | 750.00 | | |
| | | 3,250.00 | |
| | | | 24,750.00 |
| Memberships | | | 90,000.00 |
| | | | $975,750.00 |

*Liabilities and capital*

| | | | |
|---|---|---|---|
| Customers' equities: | | | |
| Market value of securities long | $1,787,000.00 | | |
| *Less:* customers' debit balances | 1,337,500.00 | | |
| Equity | | $449,500.00 | |
| Customers (short) credit balances | $42,500.00 | | |
| *Less:* market value of securities | 32,500.00 | | |
| | | 10,000.00 | |
| | | | $459,500.00 |
| Customers' free credit balances | | | 30,000.00 |
| Firm's capital: | | | |
| Partners' capital and undivided profit | | $390,750.00 | |
| Market value of securities in "securities account" | $495,500.00 | | |
| *Less:* ledger balance debit | 400,000.00 | | |
| | | 95,500.00 | |
| | | | 486,250.00 |
| | | | $975,750.00 |

*Statement B*

SNOW, FROST AND COMPANY

Questionnaire working-sheet

| | | Ledger balances Dr. | Ledger balances Cr. | Securities Long | Securities Short | Equities Dr. | Equities Cr. |
|---|---|---|---|---|---|---|---|
| 1. Total bank balances | | $75,000.00 | | | | $75,000.00 | |
| 2. Bank loans | | | $145,000.00 | | $185,000.00 | 40,000.00 | |
| Brokers | | | 1,400,000.00 | | 1,955,000.00 | 555,000.00 | |
| 3. Market value of securities in box and transfer books | | | | | 191,000.00 | 191,000.00 | |
| 4. Total ledger debit balances—customers: | | | | | | | |
| Secured | $1,337,500.00 | | | $1,787,000.00 | | | $449,500.00 |
| Partly secured | 110,000.00 | | | 90,000.00 | | 20,000.00 | |
| Unsecured | 2,500.00 | | | | | 2,500.00 | |
| | | 1,450,000.00 | | | | | |
| Total ledger credit balances: | | | | | | | |
| Secured | $42,500.00 | | | | 32,500.00 | | 10,000.00 |
| Partly secured | 7,500.00 | | | | 9,000.00 | 1,500.00 | |
| | | | 50,000.00 | | | | |
| 5. Free credit balances | | | 30,000.00 | | | | 30,000.00 |
| 6. Partners' capital and undivided profits | | | 390,750.00 | | | | 390,750.00 |
| Firm trading | | 400,000.00 | | 495,500.00 | | | 95,500.00 |
| 7. Other accounts: | | | | | | | |
| Advances to salesmen | | 750.00 | | | | 750.00 | |
| Stock exchange membership | | 90,000.00 | | | | 90,000.00 | |
| | | $2,015,750.00 | $2,015,750.00 | $2,372,500.00 | $2,372,500.00 | $975,750.00 | $975,750.00 |

NOTE.—The numbers at left hand margin indicate the questions appearing on the New York stock exchange questionnaire.

If they were not securities should be withdrawn from the brokers and placed in the safekeeping box.

The question as worded in the examination paper does not necessarily imply that the answer is to conform to the stock exchange requirements. It would seem, however, that its formulator had the questionnaire in mind and the above analysis from this standpoint may be of interest to those of your student readers who have had little or no experience in stock brokers' accounts.

Yours faithfully,

HERBERT BECK.

Chicago, Illinois, April 19, 1927.

The editors of this department wish to express to Mr. Beck their appreciation of his very clear exposition of the special principles and procedure of stock-brokerage accounting contained in the foregoing letter. This department is always receptive to correspondence of the nature of the above communication.

The rough draft of the solution prepared by the editors of this department contained statements in the general form of Mr. Beck's financial statement and questionnaire working-sheet, but these were omitted from the printed solution, it being the opinion of the editors that the statements, as published, met the requirements of the problem and that the more extensive knowledge of brokerage accounts, evidenced by the two statements submitted by Mr. Beck, was probably not contemplated by the examiners in setting the problem.

# Book Reviews

ACCOUNTING PRINCIPLES AND PRACTICE, by R. G. H. Smails and C. E. Walker. *The Ryerson Press*, Toronto, Canada, 1926. 346 pages.

*Accounting Principles and Practice* is a general treatise, in somewhat conventional form, with an expressed intention of meeting the needs of Canadian students. It begins with an explanation of debit and credit and ranges up to the interpretation of balance-sheets. There is much detail regarding books and forms for both private traders and corporations, and the usual topics of depreciation, reserves and profits are discussed in about the usual manner. There is also a side-glance at cost accounting and less familiar chapters on accounts for branches, agencies and foreign trade.

The value of a textbook can never be accurately determined until it is put to test in the classroom. Failing this it suffices to say that the book is clearly written, well arranged and made understandable by many illustrative examples. But even with these valuable features, the work does not seem of such outstanding merit as to make it indispensable either to the teacher or to the practising accountant.

Specific criticism may be made of the opening page where a renewed attempt to give a single explanation of debit and credit leads immediately, as it has in all similar attempts, to confusion and inconsistencies. On the following page the classification into personal and impersonal accounts—again a case of adherence to an outworn tradition—leads as usual to meaningless distinctions and contradictory statements.

More important is the repeated confusion regarding depreciation. The authors clearly state that the recognition of depreciation is a necessity and "cannot be omitted from the accounts, even though these already show a loss." But, not once merely, depreciation is spoken of as a charge against net profits, which it evidently is not.

Similarly, emphasis is repeatedly given to the statement that a reserve for depreciation is a means for retaining current assets with which the machine may be replaced, instead of being merely a recognition of consumed value. If a railroad begins the year with a large stock of coal, no one argues that the bookkeeping entry, showing the consumption of part of such stock, in any sense represents a provision for replacing the coal, or that it was made in order to retain current assets. A different technique for showing the consumption of value is used in the case of a depreciating machine from that used to show the consumption of coal. But the entry has, in each case, the same purpose and significance.

But enough of criticism, and this review closes with a word of appreciation of the cleverly expressed truth used by the authors as a text for the chapter on interpretation of financial statements. "The balance-sheet and operating account are not merely wayside monuments to an accounting period that is dead and buried." For this, thanks are due the authors.

HENRY RAND HATFIELD.

AN OUTLINE OF CAREERS, by EDWARD L. BERNAYS. *George H. Doran Co.*, New York. 431 pages.

This is a day of outlines and of careers. The reading public has had everything described and outlined from history to science, and the service of these syntheses is doubtless considerable. Books such as the one now under consideration are not intended to be a complete survey of the fields which they cover, but rather to present a bird's-eye view which will enable the one who reads to see the high spots in the landscape. Everyone knows that the question of vocational selection has become increasingly important with the wide development of opportunity. Mr. Bernays is largely interested in the question of vocational guidance and he has felt the need of a comprehensive review of some of the principal vocations, both business and professional. This is the incentive of the book. The subjects discussed include accountancy, art, editing, engineering, law, the ministry, motion pictures, salesmanship, the stage and a score or more of others. The chapter on accountancy is written by A. C. Ernst. This chapter is of more importance to the readers of THE JOURNAL OF ACCOUNTANCY than some of the others. It seems that the chief point which the author of this chapter makes is that accountancy offers a stepping stone to positions of importance in the business world outside professional accountancy. This, of course, is a strong inducement to enter accountancy, but it might have been well to have laid somewhat more stress upon the opportunities which the professional career itself offers to young men of ability. It is all very well to speak of accountancy as a means to an end, but better to speak of it as an end in itself. An interesting chapter on banking is written by Reeve Schley, vice-president of the Chase National bank of New York. The chapter upon law by Julius Henry Cohen is written with all the skill for which that author is well known. Mr. Cohen's comments are always well written and based upon sound experience. The book as a whole is useful as a work of reference, and it would be helpful to every young man and woman, in search of his or her most suitable life-work, to read all the chapters which the book contains.

A. P. R.

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FINANCING AUTOMOBILE SALES BY THE TIME INSTALLMENT PLAN, by WILLIAM A. GRIMES. *A. W. Shaw Co.*, Chicago. 116 pages.

William A. Grimes was awarded first prize by the Chicago Trust Company for monographs in the field of business development and the modern trust company, and in *Financing Automobile Sales by the Time Installment Plan* he has made splendid exposition of the sales and financing methods of automobiles. Every business man will be interested in the story, which is written in a most lucid manner. Of course, the book does not cover the accounting problems incidental to this financing and evidently it was not the intention of the author to discuss this feature. That would require a volume in itself. The instalment plan is comparatively new; therefore the statistical information regarding the pertinent facts is somewhat limited at this time. The book, however, presents some interesting facts about it. The author's analysis of the subject, is comprehensive and it is believed that accountants will derive much information from the book.

C. R. WHITWORTH.

CREDITS AND COLLECTIONS, by RICHARD P. ETTINGER and DAVID GOLIEB. Revised in collaboration with Herbert M. Diamond. *Prentice-Hall, Inc.*, New York. Cloth, 520 pages.

"Credit is the power to obtain goods or service by giving a promise to pay money (or goods) on demand or at a specified date in future." Therefore, it is the buyer who actually gives credit, the seller who receives it. Yet invariably we reverse this and say we "give credit" when we let a buyer have our goods in exchange for his promise to pay, specific or implied. It is a bit curious to reflect that 99/100ths of the world's business is thus founded on a paradox which would delight Chesterton.

However, after noting this paradox the authors of the book before us throw consistency to the winds and proceed to give us in customary terms an excellent treatise on the functions of credit in business and finance, domestic and foreign, the instruments used, the duties and qualifications of the credit man, and the best methods of making collections. Although its scope would appear to be limited, yet perusal of it leaves one with the feeling that he has really been reading an outline of business. In truth there is no phase of business with which the credit man must not be familiar. Internally, he must work in coöperation with the selling and financing departments. Externally, he must be capable of analyzing and judging the condition of his employers' customers, which means that he must know much about normal costs of production, market conditions, efficiency in operating, and above all the human equation. All these matters are keenly discussed on so high a plane that one is quite ready to grant the authors' claim that the credit man is a professional in all the term implies. To be sure the man who measured up to the severe requirements set forth in the book would be a veritable Admirable Crichton, and if we fear he must be rare, still he would no more than represent the high ideals expressed in the canons of commercial ethics adopted by the national association.

There is a full discussion of the advantages and disadvantages of the trade acceptance as compared with the open book account receivable, from which one may conclude that this method of settling current accounts does not appear likely to prevail in general practice. From an auditor's point of view there is one serious objection which the authors do not mention. On the whole the trade acceptance works in favor of the seller—and the banks! But in the case of the seller seeking further credit on a certified statement, his auditor must perforce show a substantial item of contingent liability for trade acceptances, assuming of course that the seller has discounted them in accordance with the whole scheme. Aside from the difficulty of verifying this item (which means written confirmation from every bank holding the paper) it is no violent assumption that a large item of contingent liability is never regarded with favor in any balance-sheet. A clear-cut item of accounts receivable, with provision for past due accounts, can be given its full weight, but a mere foot-note on the balance-sheet that the would-be borrower is contingently liable for a large sum for trade acceptances, which by their very nature must be paid immediately on their return dishonored, would make the most lenient of bankers hesitate. In theory, the bank discounting the trade acceptance looks to the drawer for payment, but who can doubt that as a matter of practice the bank will rely mainly on the acceptor, its own customer? The ultimate effect then is to limit the seller's credit to that extent, so in the end he is no better off than if he sticks to the open book account.

Procedure under the federal bankruptcy act is fully described and explained, and attention is called to the important amendment of 1926, viz., a discharge in bankruptcy is barred where the bankrupt has already been granted a discharge within six years.

It is disappointing to find no mention of arbitration as a means of settling disputes in lieu of law suits. This surely comes within the scope of the credit man's functions, since it is arguable, at least, that a resort to arbitration might well prevent precipitate legal action which might lead in turn to embarrassment. The procedure outlined for conferences and adjustment bureaus appears to be limited to action after embarrassment is experienced.

This book is intended to be a text for students and a general guide for credit men. It has been adopted as a standard text by the National Association of Credit Men, which may be taken as sufficient notice to our own profession that it is well worth a place in our working libraries. There are many practical hints applicable to our own work.

W. H. LAWTON.

# Correspondence

## NO-PAR STOCK

*Editor, The Journal of Accountancy:*

SIR: In the April issue of THE JOURNAL there appeared a review of the author's book *No-par Stock*. This review, which was written by Frank W. Thornton, contained some erroneous quotations and statements that require correction.

Mr. Thornton quoted the author as having said, on page 140 of the book, that in showing no-par stocks on the balance-sheet, accountants have "acted in sheer ignorance of the facts." This was a mistake; the word ignorance does not appear. The substitution is unfortunate because the word ignorance is of course irritating to the accused. Two identical erroneous substitutions of the word occurred in the course of the review.

Another erroneous statement of fact is made in connection with a criticism of the terminology that is followed in the book. Mr. Thornton condemns the author's use of the term "stated capital" and suggests that a term of his own, "legal capital" would describe the concept more accurately. The reasons for the author's choice of the term "stated capital" are set forth in a footnote on pages 20–21. The review did not refer to this. Mr. Thornton stated that, "As a result of this unfortunate terminology we find the author on page 30 defining the stated capital as being the stated capital plus something else." The erroneousness of this statement may be corrected by quoting from the book the sentence to which reference is made: "The amount of the stated capital of a corporation which has issued both par and no-par shares is the amount attributable to the no-par shares plus the aggregate par value of all shares having a par value for which subscriptions have been accepted by the corporation."

The review might tend to give the reader an incorrect impression of the author's attitude. It was stated that, "A quotation from page 140 of the book will serve to indicate the author's views, attitude and methods." This is followed by some quotations which, when removed from their context, would give the reader an impression that the author's attitude is harshly critical and perhaps destructive toward the accounting profession. This again is an unfortunate mistake. The reader of the review is not informed that the author is himself an accountant who has the interests of the profession at heart. The attitude of the author and intended constructive character of the book may be shown by quotation. For example, on page 143: "It is earnestly hoped that accountants will do all in their power to gain the support of no-par-stock corporations in maintaining the proper division of net worth into stated capital and surplus. The accountant may find the following arguments useful in winning his clients' support." This is followed by an enumeration of six arguments which the accountant may find helpful. Examples of the intended constructive character of the book could be multiplied. The fundamental method of the book is to attack the various problems by an analysis, to point out the possible fallacies in present laws and accounting practices, and to suggest in each instance a possible change for the better. The author's attitude is unmistakably evinced by the book itself.

The review contained certain statements which might lead the reader to believe that the book is unreliable and unauthoritative. For example, it was stated that, "The book is one which should be used only with care." This was not substantiated by pointing out any errors of theory or gross misstatements of fact. No criticism of the proposals of the book was given. But by repetition it was implied that the author's suggestions might be unreliable on account of the author's "relatively limited experience." It may be suggested that extended experience is not absolutely prerequisite to careful investigation and analysis.

The review contained no reference to the proposals or scope of the book; no mention was made of what the book undertook to accomplish or whether it succeeded. Criticism was centered on personal matters and unimportant detail, including extended criticism of two relatively unimportant footnotes and the citation of an exception to a generalized statement. The review was strictly derogatory throughout.

The cause of the review may be explained by the possibility that Mr. Thornton did not recognize that the author felt it necessary to emphasize some of the fallacies that are current in accounting practices in order to initiate the suggested changes, and was offended by the emphasis. If this is true, the author is regretful.

Yours truly,

CARL B. ROBBINS.

Cambridge, Mass., April 13, 1927.

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*Editor, The Journal of Accountancy:*

SIR: The reply of Carl B. Robbins to the review of his book is before me. He is correct in his statement that he said accountants acted in sheer "innocence" of the facts, not "ignorance." I apologize to Mr. Robbins for the mistake and if the "accused" accounting profession feels aggrieved at being charged with being innocent of facts rather than ignorant of them I apologize to it also.

Apart from this point, however, the reply seems to call for no modification of the criticism offered in the review.

Mr. Robbins suggests that the quotation from page 140 is unfair because it is removed from its context. It covers two complete consecutive paragraphs, in which the author formally undertook to state the "attitude of accountants."

He complains that his attitude towards accountants is misrepresented, but the illustrations he gives merely emphasize his pedagogic attitude, and his reference to them as the "accused" is an illuminating, if unconscious, disclosure of his state of mind.

The author's discussion of the criticism that he relied on second-hand evidence is unconvincing. There is nothing in the accounts of Famous Players Lasky Corporation for 1921 to suggest that its no-par stock was then stated on the basis of its market value, but the author, on his own statement, was content to give further currency to the suggestion that the corporation's accounts, certified by responsible auditors, contained an egregious error of which he could find no other example in the published reports of corporations.

Mr. Robbins says I "assumed that the shares were carried at their stated value." I did not assume anything; that is not the procedure followed by accountants. I investigated, as Mr. Robbins might have done, obtained precise information and gave it; and I did not call the value at which it was set up "stated" value.

Essentially the criticism of the book was that it lacked depth and breadth of scope and of understanding. The author's reply fails to dissipate this impression.

Yours truly,

FRANK W. THORNTON.

New York, April 18, 1927.

## TREATMENT OF RESERVES

*Editor, The Journal of Accountancy:*

SIR: I have read with interest Professor Cole's article entitled, *A Confusion of Terms* in the March number of THE JOURNAL OF ACCOUNTANCY.

I agree with the author that the word "reserve" is not the most happy one to use in connection with depreciation. I do not, however, agree with his assertion that a reserve for depreciation represents nothing but an over-valuation of assets. To my mind it is also a liability for the restoration of the impairment of capital assets. It is an estimated liability to be sure, but nevertheless a liability which must be met sooner or later if the business is to continue to operate on a paying basis.

In order that the liability aspect of a reserve for depreciation may not be lost sight of, I favor its being shown on the liabilities side of the balance-sheet instead of as a deduction from the asset, as in the case of a reserve for uncollectible accounts. In preparing the profit-and-loss account, depreciation is considered as an expense. Instead of designating the liability for depreciation as an "allowance," why not simply call it "accrued depreciation," the same as accrued wages, accrued taxes or other expenses which have accrued but which have not been paid?

Yours truly,

HAROLD C. ANDERSON.

Washington, D. C., May 9, 1927.

# Current Literature

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Commonwealth Journal of Accountancy, 59 William Street, Melbourne, Australia.
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# THE JOURNAL OF ACCOUNTANCY

VOL. XLIII
JANUARY, 1927—JUNE, 1927

NEW YORK
THE JOURNAL OF ACCOUNTANCY, INCORPORATED
135 CEDAR STREET

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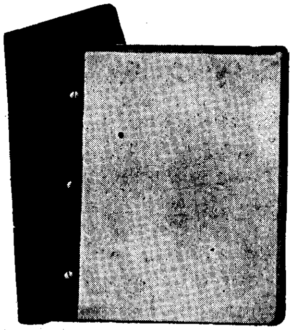

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