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Book Reviews

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DEPRECIATION IN PUBLIC UTILITIES, by DELOS F. WILCOX. *National Municipal League*, New York. 112 pp.

Depreciation in Public Utilities is the second monograph in the series which is being published by the National Municipal League and, according to the prefatory note, "Dr. Wilcox has presented in this monograph the theory and application of accrued depreciation as particularly related to street railways. He has shown why he thinks this method of treating depreciation in public utilities is preferable to other methods. To substantiate his position, he has summarized the experience of a number of municipal railway systems".

The book is divided into three chapters, the first two being devoted to a dissertation on the theory of accrued depreciation and the last chapter being a resumé and criticism of street-railway practice by the operating companies in ten cities, viz.: Chicago, Cleveland, Montreal, Grand Rapids, Milwaukee, New York, Boston, San Francisco and Detroit.

The author is an avowed theoretical depreciationist of the "age-life straight-line" school and throughout the book takes pot shots at the opponents of the theory in no uncertain language, but like most of those who think as he does in respect to depreciation as applied to public utilities, his arguments are far from convincing, being merely a re-hash of those which have met with disfavor in rate proceedings of recent years.

Kind reader! if you will visualize an inverted right-angle triangle, you have before your mind's eye a perfect picture of the battle ground of depreciation. The hypotenuse represents the line of march of the straight-line theoretical depreciationists, whereas, the two subtending sides reflect the itinerary of the actualists. In other words, the theorists, to whose cause the author is an ardent adherent, contend that "property is diminished in value in proportion as its total service life is exhausted". The actualists, however, place fact before theory and argue that as long as the property as a whole is maintained, by repairs and replacements, at a high standard of efficiency, there is no loss in value until a unit is withdrawn from service for any cause (except that reflected by "deferred maintenance"). The loss at the time of withdrawal, which is not looked upon as accruing by degrees, is provided for in the accounts by an equalization reserve, the credit balance of which is deemed a mere segregation of surplus and not an abatement of fixed capital values.

The summary of the experience of the municipal railway systems in the last chapter of the book falls far short of substantiating the author's position, as prognosticated in the prefatory note. In fact, the preponderance of conclusions and opinions cited would seem to repudiate his theories and the citations might well be included in the brief of those who disagree with him.

The outstanding weaknesses in the age-life straight-line theory of depreciation, as applied to public-utility property, are:

(a) It presupposes an "inexorable, inevitable law of decay" which operates by mathematical formulas.

(b) Its adherents are far from agreement as to the proper rates to be used for each class or unit of property and as to what consideration should be given to differing conditions and standards of maintenance.

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(c) It takes no cognizance of foreshortened lives due to obsolescence, inadequacy or disuse from other economic causes.

(d) It completely closes the door to the consideration of changes in price levels, a necessary element in arriving at "present value" which the United States supreme court has held to be the proper basis upon which to predicate a fair return.

(e) It inferentially brands as legally dead any unit of property which has "lived" beyond its estimated "service life" and denies the propriety of any return whatsoever thereon.

As an expedient, and as applied to property other than that owned by public utilities, where selling prices are determined largely by the law of supply and demand, and where fixed capital values are not determining factors in arriving at "rates", the application of theoretical depreciation formulas is a simple and inexpensive method of estimating an item of expense, necessary for the determination of profits available for distribution or subject to tax. It is, however, an expedient only and should not be crowned with a halo of accuracy when facts are offered in its place.

In relation to the deduction for federal income-tax purposes of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence", the following excerpts from Montgomery's *Income-tax Procedure*, 1926 (pp. 1377 and 1378) are of interest as an indication of the trend of opinion of those qualified to speak authoritatively, and from an unbiased standpoint, on the subject of straight-line depreciation.

In measuring the "reduction", in order that it may be converted into a dollar and cent expense, the treasury has on the whole conformed to good accounting principles. Nevertheless it must be recognized that in the past good accounting practice has been governed largely by expediency, since at the best the measurement of exhaustion or depreciation is an estimate. For that reason there has grown up a rather slavish adherence to the principle that the reduction in value is "gradual". In many instances it is not. Some machinery is like a good saddle. Its value new is something less than its value "broken in". But to break away from the partly erroneous "gradual" theory to the more complicated evaluation theory may not be practicable in the administration of income-tax laws. There is, however, no good reason why taxing authorities should argue that the "gradual" exhaustion principle is a true one. It is far, far from that and it merely makes some of the rulings, in the endeavor to support a fallacious theory, sound quite foolish.

In *Tiedemann Sons' appeal* (I. B. T. A. 1077) the taxpayer for some years arrived at its deduction by valuing its depreciable assets at the beginning and end of each year. . . . The commissioner substituted the straight-line method and found a deficiency. . . . The author regrets that a good word was not said for a method which may be in force some day. The "straight-line" basis may not survive.

The following excerpt from the United States board of tax appeals reports in the *Appeal of The Kinsman Transit Co.*, decided January 31, 1925, is quoted as further evidence of the trend of opinion of those who (to borrow Dr. Wilcox's phraseology) are not concerned with "propaganda in connection with valuation and rate cases" and are not "subsidized experts" or "appraisal engineers trained not to see what the owners do not wish them to see".

There are a number of methods of computing depreciation which lead to widely different results and each method has its particular advocates.

Experts themselves admit that it is a guess even when based upon inspection or relevant facts, yet we are asked to adopt a formula which can be applied to bulk freighters as a theoretical yardstick in measuring the depreciation sustained by them over a period of years, without any showing of the actual depreciation sustained by the particular vessels herein. This we decline to do, and the reason therefor must be obvious. Assume two vessels in all respects alike, launched at the same time and costing the same amount. Due to accidents, use or abuse, neglect of repairs, and the numerous hazards incident to navigation, at the end of ten years one of the vessels may be ready for the scrap heap, while ordinary prudence in the use of the other and freedom from accidents may keep down depreciation to the minimum. If, however, we apply the formula suggested, both vessels would be of equal value at the end of any particular period, and the same result would ensue from the application of a flat rate of theoretical depreciation. We are not prepared to countenance such results. The value of any vessel at a particular time is a question of fact which must be proved by competent evidence. The reconstruction cost less actual depreciation sustained is important evidence of value and has in it important elements to prove either the market value or actual value; but depreciation is ordinarily something to be concretely determined by inspection, and in determining the rate of depreciation to be applied to property of the character herein for the purpose of ascertaining value as of a particular date in the past it is highly important that the history of the vessel, the character of repairs, the actual use to which the vessel has been put, and all relevant facts tending to show the depreciation sustained be placed before us, and upon these facts, assisted by the testimony of such expert witnesses as may be produced, a fair judgment can be exercised as to the amount of depreciation sustained which will more nearly approximate the actual depreciation sustained than the application of a formula or flat rate of theoretical depreciation which only serves to produce grotesque results.

It is also of interest that a number of public utilities, in reporting their taxable income for some years past, have been deducting from income their actual withdrawals, instead of any estimated theoretical figure and this method has been acceptable to the tax authorities.

The writer of this review has purposely omitted any quotations from recent rate proceedings in respect to the application of theoretical depreciation as the denunciations are too eloquent to permit of paraphrasing or summarizing and lack of space prohibits a full recital of outstanding decisions.

In any event, a perusal of recent decisions would merely intensify the impression, rapidly gaining ground, that, as applied to public utilities, the one thing that has truly depreciated is the age-life straight-line theory. It is rapidly approaching the lower end of the hypotenuse, the zero point in value and may even suffer a foreshortened life due to obsolescence.

The life of the theory may be prolonged by a replacement of thought on the part of its adherents but they are determined, apparently, to cling to and fight for their convictions to the bitter end, to go down with flags flying and to become apt candidates for the time-honored motto "Mutare vel timere sperno" (I scorn to change or fear).

EDWARD H. MOERAN.

ACCOUNTING FOR UNIVERSITIES, by EARLE L. WASHBURN. *The Ronald Press Co.*, New York. Cloth, 126 pp.

The author of *Accounting for Universities* is an experienced university accountant and has had the difficult task of condensing and presenting, in a few

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pages, information on a subject which is extremely complicated and about which little has been written. On the whole, Mr. Washburn has done well. The greater portion of the volume is, of course, devoted to describing the books to be used, submitting forms for these books, explaining and submitting entries for recording various facts, for closing the books, etc., and explaining the method of preparing the budget and the annual statements.

Probably because of lack of space, some of the problems which are peculiar to universities, and upon which opinions differ, are passed over in a very few words. For example, the question of depreciation is disposed of in one paragraph, the gist of which is that universities should not maintain depreciation-reserve accounts. This question of depreciation is one which has been discussed at many conferences of university business officers and is one concerning which there are many different opinions. Some of the most thoughtful university officers, however, are gradually coming to the conclusion that annual depreciation should be taken on all the depreciable property of educational institutions, and that such depreciation should be funded by placing an equivalent amount in a separate bank account or by investing it in securities.

The statement is made that a privately endowed institution does not even aim to equalize its income and expense, but depends upon gifts to offset any deficiency. Here, again, there seems to be a definite trend of opinion toward at least "coming out even" each year; in fact, some institutions feel that expenses should be kept well within income so that a surplus may be accumulated which can be used to aid the growth of the institution.

It seems to be the general opinion that the accounts of an educational institution should be maintained on a cash-receipts-and-disbursements basis. Granted that this basis should be used, the question arises as to how the purchase of fixed assets out of current income should be recorded. If such purchases are charged to a fixed-asset account, as they are under Mr. Washburn's plan, the surplus account will include both the investment in plant and the surplus from operations. Since the availability of current funds is the important consideration, would it not be better to separate fixed-asset accounts from operating accounts? This brings us to the method, advocated by Trevor Arnett, of having the accounts divided into three sections: endowment, plant and operating. Each section would be made self-balancing, the balancing factors being fund accounts which measure the net worth of each section. Under this plan, a disbursement from current (operating) income for fixed assets purchased would be charged to operating expense, and at the end of the year, in order to maintain a complete record of total physical plant, an entry would be made charging equipment account and crediting fixed-asset fund account. In this way, operating-fund account (surplus) would be reduced by the cost of such equipment, and properly so, for the money is no longer available for any other purpose.

A balance-sheet prepared under Mr. Washburn's system may be very misleading. For example, in the balance-sheet of a certain university as at June 30, 1924, there appears opposite surplus an amount of \$4,600,000. Upon analysis of this item, however, it appears that it is made up of approximately \$4,900,000 representing the investment in fixed assets, less an operating deficit of almost \$300,000. A further examination shows that a portion of this operat-

ing deficit represents a bank overdraft of almost \$200,000. The point here is that while it is a splendid thing to have \$4,900,000 worth of fixed assets, the important thing to bear in mind is that this amount is not available for current purposes. By crediting the amount of these fixed assets to surplus account the fact that at June 30, 1924, the university was perhaps in a rather difficult situation with respect to current usable funds is unconsciously concealed.

W. B. FRANKE.

ACCOUNTING THEORY AND PRACTICE, by ROY B. KESTER. *The Ronald Press Co.*, New York. Second edition revised. Cloth, 855 pp.

We have now the second volume of Professor Kester's well known three-volume college text on accounting theory and practice, revised and enlarged. The principal changes from the earlier edition are the rearrangement of material in more logical sequence, the elimination of more or less irrelevant details, the addition of more adequate treatment of no-par-value stock, consolidated statements, interpretation of balance-sheets, and more practice problems—all decidedly important and up-to-date. Of the thirty-seven chapters the first thirty-three deal with the balance-sheet—its form, content and related accounting problems, making a complete study of accounting for going concerns. The thirty-fourth chapter gives the student much valuable instruction in the important art of interpreting the balance-sheet, a matter that has had rather scant attention in accounting texts. The last three chapters cover liquidation in all its forms and the accounting for estates and trusts, somewhat briefly, but enough to enable the student to grasp the principles involved.

Two appendices, comprising 140 pages, contain practice problems for the student, appendix A consisting of a continuing series of transactions based on the chapters of the text in consecutive order, and covering the two semesters of the second college year; and appendix B containing problems, disconnected but definitely related to like-numbered chapters of the text, thus affording additional practice work, or work for alternate years, as the instructor may desire. The problems are fair tests and typical of what may be asked in C. P. A. examinations.

The author speaks rather slightly of the liquidation statement—it has “no basis in practice, is purely theoretical, and any discussion of it is largely academic. It is presented here only because it is so frequently met in the formal examinations for the C. P. A. certificate”—a gentle “slam” at the examiners which I believe is not quite warranted. The fact that problems are frequently set in this subject seems to indicate that practising accountants find it useful, and because courts and lawyers use rule-of-thumb methods is no good reason why accountants should not seek to put the subject on a sound logical basis. However, waiving the practical side of it, the inclusion of liquidating principles and forms rounds out the theory of accounting which would otherwise be incomplete.

The matter of valuation of merchandise stock-in-trade is treated in a broad, comprehensive and logical way, though it may come with something of a shock to the orthodox to hear that there can be any basis of valuation other than “cost or market, whichever is lower”. Professor Kester makes it quite clear that inventory valuation depends largely on its purpose. There is the actual

cost basis for ascertaining true profit; there is the market or replacement value for credit purposes; and, it may well be added, there is a forced-sale basis for liquidating purposes. The author seems to favor for credit purposes the basis of selling-price-less-expenses, his theory as I understand it being that the total value of the inventory realizable by the reporting concern is thus made clear to the creditor. His procedure would be to carry the inventory at cost and show the estimated increase or decrease in memorandum accounts by the entry:

Merchandise valuation

To estimated profit and loss from sales valuation of merchandise inventory.

The accounts would appear on the balance-sheet and in the non-operating income section of the profit-and-loss statement. For the balance-sheet I do not see much to be gained by this procedure; in my own practice where such information is desired I prefer to state the inventory at cost with a parenthetical note showing the market value in the same way that investments are shown. Nor can I quite agree with the author's logic as to the place of these accounts in the profit-and-loss statement. No income, operating or non-operating, has been realized from this source for the period. If shown at all it should appear only as an item of increase or decrease of surplus.

There is a rather careless statement on page 129 as to the correct figure to be shown for cash on the balance-sheet. An auditor may be justified in showing "an adjusted amount" as the correct cash balance in his report, but I can hardly believe that Professor Kester would seriously approve a student's balance-sheet which showed cash differing from the cashbook! From the text following it is indicated that he is referring to the cashbook balance before proper corrections and adjustments, but the average student would need an explanation.

On page 537 the author says, in the case of stock dividends received:

If stock dividends are declared their amount is debited to the investment account and credited to dividends earned.

I doubt if this will be accepted as the correct procedure. As far as the holding company is concerned this is not an earned dividend but merely a formal recognition of appreciation in the value of its ownership. As such it should be credited to surplus, or to some suspense account if it is to be sold immediately. The ultra-conservatives who would make no book entry at all beyond showing the number of additional shares acquired are logically justifiable, though I agree with Professor Kester that it would be better to record the stock dividend at its value. But in any event it is not an earned dividend and should not be so recorded.

An old controversy turns up in the discussion of the question of whether or not a depreciation reserve is necessary where a trust agreement requires a sinking-fund reserve to be provided by charges against current profits. After stating briefly and lucidly the arguments pro and con, the author seems rather non-committal about it, perhaps because like the majority of us he considers it an academic question. If the sinking-fund provision is carried out, the omission of depreciation does no particular harm, because in the end the sinking-fund reserve may be charged off against the asset affected, and no principles of accounting are necessarily violated. On the other hand, failure to record depre-

ciation results in an inflated showing of net profits; or if the sinking-fund reserve is charged against profits, the showing of profit and loss is thereby corrected, but there has been no real reservation of profits, the sinking-fund reserve being in reality a valuation account for the asset, and so the letter of the trust agreement is violated. And there you are! However, in the light of income-tax laws the problem is not academic by any means. Depreciation is an allowable deduction, while reserving from profits for the sinking fund is not. The average corporation will not pay unnecessary taxes on ignored depreciation because of a technical grievance of the stockholders. In actual practice the accountant will scrutinize closely the terms of the trust agreement and if possible ignore the sinking-fund-reserve provision. That is, if such agreement can be construed to mean (as it usually is intended to mean) merely that a stated sum is to be set aside for the purpose of eventually paying off the bonds, such action will be considered substantial compliance with the trust agreement, and no reserve will be set up. Where the trust agreement does insist explicitly upon a sinking-fund reserve, the stockholder must grin and bear it unless he is willing that his company shall pay unnecessary taxes.

So much for the book as a college text. But for the practitioner it is more than that. It is a real study of accounting theory and practice in the light of the latest thought, written by one who evidently delights in his work and knows how to express himself. For logical arrangement, clearness of exposition and freedom from unnecessary irrelevance I have read nothing better. Being fairly well "fed up" with accounting literature in this line I feel entitled to speak with some conviction. As an alumnus of some forty years' standing it gives me a pleasant feeling that such a good piece of work has come from my university, Columbia.

W. H. LAWTON.

PRACTICAL ACCOUNTING FOR GENERAL CONTRACTORS, second edition, by H. D. GRANT. *McGraw-Hill Book Co.*, New York. Cloth, 329 pages.

Practical Accounting for General Contractors has been written to provide a handbook for one who keeps the accounts of a general contractor. "The author some years ago was engaged to take charge of the accounting department of a large contracting concern. . . . A system of accounts and accounting control was evolved which fulfilled the essential requirements by giving the contractor the information he required for the management of his business. . . . This book contains a description of the system, to which is added a discussion of the methods and accounting practice in those contracting businesses where adequate records are kept." (Author's preface, page vii.)

The contents are divided into four parts: I, Financial accounting; II, Field accounting control; III, Miscellaneous matters; IV, Accounting procedure for small contracting business. Part I includes approximately one-half of the text material.

Under financial accounting the author first describes the various types of contract agreements: lump-sum, upset limit, fixed fee, unit price, jobbing and cost-plus. He then explains the financial accounts and records, including the procedure for financial cost accounting, materials control, income and expense records and the periodic statements.

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Field accounting control covers such topics as unit costs, organization and personnel, classification and symbolization, field accounting records and monthly reports to the owner. Under miscellaneous matters the author discusses payroll problems, equipment control, estimates and bids, municipal contracts, and the legal aspects of contracts. The final section indicates the details of procedure for a small contracting business and suggests a model set of accounts.

The book has not been prepared for classroom use. It is very definitely addressed to readers familiar with the field of general contracting. Consequently the author makes slight attempt to define technical terms as they are introduced into the material. The diction is informal, but for the most part clear. Numerous forms are suggested, and their use is completely explained. At various points, the author strays from the path of practical suggestions into the fields of accounting theory and economics. In some instances he finds himself on unfamiliar ground. For example, he states that in lump-sum contracts the entries for the original or extra orders on the contractor's books should be:

Debit: Owner

Credit: Unearned contract sales

He then suggests that when cancellations or modifications of orders are made, the credits should be entered in red on the debit side of the owner account, so that the credit side "will show only the actual cash collected." Similarly the debits should be entered in red on the credit side of the unearned-contract-sales account so that the total would be reduced to the "proper status of net sales." Would it not be better for purposes of practical control to record separately the effects of cancellations and modifications? The above situation might be met by a journal entry similar to the following:

Debit: Cancelled contract sales

Credit: Owner's cancellations

These account balances could be offset against the totals in the owner and unearned-contract-sales accounts at the close of an operating period or at the completion of a contract.

Where the author is discussing the proper basis of materials valuation on cost-plus contracts, the question arises: "What is the proper price at which to charge the owner where material for the contract is supplied from the contractor's own stock"—cost or market? "If the latter price is higher, the contractor, in the opinion of the author, should charge the owner on that basis." The support of this contention is not the simple fact that the owner would in any event be forced to pay the market price, but that the market price "would compensate the contractor for interest on his investment in the inventory for the period between purchase and sale." The author also suggests that "should the (original) cost to the contractor have been higher than the (present) market price, the former price should be taken. . . . The contractor is entitled to some protection from loss and he therefore sells the material to the owner at cost." One can scarcely imagine an owner in a cost-plus contract permitting a contractor to supply goods at a price which prevailed at a period preceding negotiations, if it were possible to obtain them now at a lower figure in the open market.

C. RUFUS ROREM.