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Students' Department

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Students' Department

EDITED BY H. A. FINNEY

(NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official solutions of the American Institute of Accountants. They merely represent the personal opinion of the editor of the *Students' Department*.)

AUDITING

NOVEMBER 15, 1923, 9 A. M. to 12.30 P. M.

Answer all questions.

1. Define—

- (a) a balance-sheet.
- (b) a comparative balance-sheet.
- (c) a consolidated balance-sheet.
- (d) a double-account balance-sheet.
- (e) a fund balance-sheet.

Answer:

(a) A balance-sheet is a statement of assets and liabilities prepared from a double-entry ledger after closing. Strict accuracy of terminology requires that this title shall not appear on a statement of assets and liabilities prepared from single-entry records and other memoranda.

(b) A comparative balance-sheet consists of two or more balance-sheets of the same company drawn from the books at different dates. The comparative balance-sheet is usually arranged with three columns on the asset side and three columns on the liability side. The first two columns are used for the balance-sheets and the third column is used for increases and decreases, or there may be an increase column and a decrease column on each side.

(c) A consolidated balance-sheet is a statement of the assets and liabilities of a group of related companies prepared in such a way as to show the financial condition of the group in relation to the outside world, after eliminating any accounts which represent relations between the companies. The term is sometimes used to denote the balance-sheet of a company with branches, in which the assets and liabilities shown on the books of the home office and of the branches have been combined. This use of the term, however, is not recommended.

(d) A double-account balance-sheet is a statement of assets and liabilities divided into two sections, one devoted to the current assets and liabilities, and the other devoted to the remaining assets and liabilities. The current assets are listed on the left side, the current liabilities are listed on the right side, and the balance, or working capital, is entered on the right side and the first section is ruled up. The working capital is then brought down on the left side in the second section and the balance-sheet is completed by entering the remaining assets and liabilities and again ruling up.

(e) The expression "fund balance-sheet" is usually understood to denote the statement of assets and liabilities of a municipality, classified according to governmental functions.

Students' Department

2. In a detailed audit how would you verify and value the item "accounts receivable"?

Answer:

The verification of accounts receivable in a detailed audit may well begin with an examination of the order or shipping records. The object of this examination is to determine whether all goods shipped during the period have been charged to customers. It is usually sufficient to limit this work to a test of a few weeks or a month, tracing all shipment records into the sales records. As sales records frequently consist of duplicate invoices bound and summarized, it is also necessary to make a test to see that all invoices have been included in the summary. This involves checking from the duplicate invoices to the summary, which should then be footed. The postings should be verified, but when a controlling account is kept it is usually considered sufficient to prove the posting of the totals to the controlling account. This is done on the theory that if the controlling account is correct, and if the trial balance of the subsidiary ledger agrees with the control, the detailed posting must have been made, although not necessarily to the proper personal account. It is usually thought to be safe to rely upon the customer who was incorrectly charged to bring erroneous postings of this kind to light.

Having verified the charges, attention should next be given to the credits. In order to be sure that lapping has not taken place, it is advisable to compare the daily receipts and customers' credits with the bank deposits for a series of successive days. The controlling account column in the cash book should be footed and the postings verified.

Attention should then be given to non-cash, or journal credits to customers, to be sure that fraud is not being covered by unauthorized credits for returns and allowances or for discounts.

A trial balance of the subsidiary customers' ledger should then be checked against the customers' balances to be sure that all customers' accounts are represented in the trial balance and that no balances appear in the trial balance which are not represented by accounts. The trial balance should then be footed and the total compared with the balance of the controlling account.

The accounts receivable should be examined in detail to determine whether any accounts are old and probably uncollectible, to discover whether accounts with officers and employees are improperly included among the customers' accounts, and to ascertain whether consignments have been improperly classified as accounts receivable. If the client will consent to such a procedure, it is advisable to send statements to all customers with a request for confirmation.

3. Do you consider the periodizing of the outstanding accounts-receivable balances as the best method of determining the adequacy of the reserve for bad debts? Give reasons.

Answer:

While the determination of the age of each customer's account is desirable in determining the adequacy of the reserve for bad debts, it is

usually not necessary to undertake the work of complete periodizing of all outstanding accounts by classification in columns for various ages, such as 30 days, 60 days, 90 days, etc. The preparation of a complete periodizing analysis of all accounts involves a great deal of work and is rarely undertaken except under unusual circumstances. It is usually considered sufficient to scrutinize each account and determine whether it is so old that it will probably not be collected. Such old accounts can then be noted on the trial balance and be taken up for discussion. This much work should certainly be done.

A reserve equal only to the estimated loss on old accounts will usually not be adequate to cover the total loss on all open accounts because of the fact that many accounts which are current at the date of the balance-sheet will finally lag into the past-due status and will not be collected. If the reserve is to provide for all probable loss on accounts now current as well as on past-due accounts, it is advisable to supplement the periodizing process by determining the ratio of bad-debt losses to sales in past periods. The rate of loss thus ascertained to have applied in the past should then be applied to the sales of the period in order to determine the loss which will be sustained in the future if the accounts now on the books prove to be uncollectible to the same degree that prevailed in the past.

4. Corporation A has taken over the assets and liabilities of corporations B and C. The assets and liabilities have been merged with those of corporation A. In what circumstances may the amount of the goodwill account of corporation A be (a) decreased; (b) increased?

Answer:

When a corporation buys the assets and assumes the liabilities of another company, an appraisal should be made to ascertain the present value of the properties taken over. If the purchase price exceeds the value of the net assets as thus ascertained, the excess is usually regarded as goodwill, and may be added to the goodwill account of the purchasing company. On the other hand, if the value of the net assets as shown by the appraisal exceeds the purchase price, there does not seem to be any necessity for applying this excess as a deduction from the goodwill already on the books of the purchasing corporation or added to the account as a result of excess payments made in the purchase of the net assets of other companies. If the purchasing company had a valid goodwill of its own, or if it paid for goodwill in acquiring the net assets of one company, this goodwill can scarcely be said to be reduced by a fortunate purchase in acquiring the assets of another company at less than their real value. It would seem, therefore, that the purchasing company would be justified in putting the assets thus fortunately purchased on the books at their appraised value, and setting up a capital surplus account for the excess of the value of the net assets over the purchase price.

5. You are examining the accounts of a mercantile corporation which has several selling branches but all shipments are made and all customers are billed by the main office. It is not intended that you shall visit the branches. Outline a procedure for the verification of the branch balances.

Students' Department

Answer:

It is rather difficult to answer this question because the question does not contain much information as to the nature of the accounts kept by the branch. When a selling branch merely takes orders which are shipped from the home office and billed by the home office, the branch records usually consist only of a cash record of expenses. A working fund is maintained at the branch, which should in reality be called an agency, and this working fund is replenished by the home office after the agency submits a statement of expenditures.

The best procedure would be to delegate some local accountant to make an examination of the branch records and verify all expenditures by examination of the vouchers. This, however, may be ruled out of the answer by inference, for the question states that the auditor in charge is not to visit the branch. This may mean that he is not to delegate an agent. If this is the case about the only way that an adequate verification of expenditures could be made, would be by having the branch forward its vouchers to the home office where they could be examined.

6. On February 15, 1924, you are called on to audit the books of a concern for the calendar year 1923. State in detail how you will verify as of December 31st the balance-sheet items (a) cash, (b) notes receivable, and (c) accounts payable?

Answer:

(a) A certificate should be obtained from the bank, stating the amount of the cash balance at December 31, 1923. The cash on hand should be counted at some date as soon after February 15, 1924, as possible, and the bank should be requested to furnish a statement with canceled cheques as of the same date as the cash count. The bank account should then be reconciled as of the date of this statement, and the balance at December 31, 1923, should be determined by working back from the balance at the date of the cash count. This is accomplished by adding to this balance all disbursements since December 31, 1923, and deducting all receipts. This work should be done in addition to the comparison of receipts with bank deposits during the period, and the checking of canceled cheques against the cash book. The extent of this detail work would depend upon the scope of the audit.

(b) A list of the notes receivable on hand at the date of the audit should be prepared, and verified by inspection of the notes or by certificates from any depositaries. In order to work back to the notes on hand at December 31st it will be necessary to eliminate those notes which have been received since that date, and to add back any notes which the records show to have been paid or otherwise disposed of during the interim.

(c) Statements received from creditors as of December 31st should be compared with the accounts payable appearing on the books. Entries made in the records during January for purchases, expenses or other expenditures, should be checked against invoices and other vouchers to see whether any of the items are applicable to the preceding year.

7. After all credits, exemptions and deductions A and B have net incomes of \$7,500 each. All of A's income is derived from dividends on

stocks of domestic corporations; B's from salary and commissions. At what rates will each be assessed under the federal income-tax law of 1921?

Answer:

Assuming the income was received after January 1, 1922:

A 1% surtax only on \$1,500.

B Normal tax:

\$4,000.00 at 4%.

3,500.00 at 8%.

Surtax:

\$1,500.00 at 1%.

8. A died February 14, 1923. What return or returns under the federal income-tax law of 1921 should be made by A's executor, and when?

Answer:

(1) A return should be made for the portion of the year during which the decedent lived, which return the executor or administrator *may* file immediately after his appointment and qualification without waiting for the close of the taxable year. Any income return required to be filed for a decedent is due on the fifteenth day of the third month following the close of the taxable year during which the decedent dies.

(2) A return is required during the period of administration of the estate, which is due on the fifteenth day of the third month following the close of the taxable year of the estate, but upon completion of the administration of the estate and final accounting an executor or administrator *may* immediately file a return of income of the estate for the fractional part of the taxable year in which the administration was closed, attaching to the return a certified copy of the order for his discharge.

9. In 1917, A bought 100 shares of stock for \$10,000. In 1922 he received an "extra dividend from profits earned prior to 1913" of \$2,000. Thereupon (1922) he sold the stock for \$6,000. What return of these transactions should he make for 1922?

Answer:

(1) The dividend of \$2,000 from profits accumulated prior to March 1, 1913, is not taxable and should not be reported.

(2) A loss of \$2,000 should be deducted in the return for the year 1922. This loss is computed as follows:

| | |
|--|-------------|
| Cost of stock | \$10,000.00 |
| Selling price | 6,000.00 |
| | \$ 4,000.00 |
| Loss | \$ 4,000.00 |
| Tax-free distribution applied to reduce loss.... | 2,000.00 |
| | \$ 2,000.00 |
| Remainder, deductible loss | \$ 2,000.00 |

10. In certifying without qualification to a balance-sheet what responsibilities—financial, legal and moral—to your client and to the public will you consider that you have assumed?

Students' Department

Answer:

In certifying without qualification to a balance-sheet, an auditor assumes a legal responsibility for having exercised ordinary skill and diligence in determining that the balance-sheet represents the true financial condition of the concern. He certainly would be liable for willful concealment of essential facts and would theoretically be liable for negligence which resulted in a failure to determine significant information. However, the legal decisions do not furnish very definite or satisfactory standards for determining when an auditor has been guilty of negligence.

Under present conditions, therefore, the auditor should feel a greater moral responsibility than is imposed upon him by law. He should feel a responsibility for submitting a statement which discloses the financial condition in an essentially truthful manner. An important item must not be omitted or classified in such a manner that its real significance will be lost sight of; but this rule does not apply necessarily to items which, by comparison with the other amounts in the balance-sheet, are so trivial as to be relatively insignificant.

FEDERAL TAXES AND EMPLOYEES' BONUSES

Several months ago some space was devoted in this department to a discussion of the question of the propriety of deducting federal taxes from profits in arriving at net profits subject to bonuses. The following letter from an attorney cites a number of court decisions which may be of interest.

The editor doubts whether English decisions are conclusive, partly because of the differences between the English and the American laws, and partly because the decisions are those of English courts. The editor also questions the validity of the argument in the last part of the letter, dealing with departments. There are certain general expenses which are not easily distributable among departments. If an employee's bonus is to be based on the profits of a particular department it probably would not be proper to deduct a portion of the interest, for example, paid on bonds and other liabilities. But that does not mean that the interest would not be properly deductible in determining the net profits of the business as a whole, if an employee were entitled to a bonus based on the total profits.

Editor, Students' Department:

SIR: I have read the discussion of the question of federal taxes and employees' bonuses in the *Students' Department* of your issues of July and December, 1922, and June, 1923, and have found them both interesting and instructive. But, as the matter is left rather undecided, I thought you might appreciate a brief outline of the court decisions upon the question as I have found them in my research.

The question has not been passed upon by an American court of last resort to this date, so far as I can ascertain. There is one decision squarely in point, however, which was rendered by an inferior court and is reported in the 199 *New York Supplement*, at page 617. It is the case of *Stanley vs. Leary*.

In that case, following closely the reasoning of Mr. Charles F. Seeger, the court holds as follows:

"The compensation of an employee is an expense of the business and is properly deductible before taxes are paid. The authority for such deduction is found in section 214 of the law (Revenue Act 1918, 40 St.

1066) U. S. Compt. St. Ann. Supp. 1919, 6336 1/8 g), which provides that all necessary expenses, 'including a reasonable allowance for salaries or other compensation for personal services actually rendered,' may be deducted, and the amount of such deductions is not subject to review by the treasury department. *United States vs. Philadelphia Knitting Mill Co.* (D. C.) 268 Fed. 270. A bonus paid to employees is deductible (Rossmore on Federal Income Tax Problems (1922), p. 113); so are salaries in the form of contingent compensation (Rossmore, p. 116). The right to deduct a salary based upon the amount of business done on the theory that such is an expense of the business has been recognized in *Bennett vs. Millville Imp. Co.*, 67 N. J. Law, 320, 323, 51 Atl. 706. That question was not passed upon by the circuit court of appeals in *Ransome Concrete Machinery Co. vs. Moody*, 282 Fed. 29. The district court expressed no opinion on that question, 282 Fed. 36. * * * It would seem, therefore, that inasmuch as the amount of plaintiff's commission was deductible as an item of expense, such computations should be based upon the profits before any deduction for the payment of taxes."

An examination of the case of *Ransome vs. Moody*, 282 Fed. 29, will confirm one in the opinion that the decision of the New York court is the correct solution of the question. In that latter case the court said (page 36):

"As to the second proposition, I agree with the reasoning of *Patton, etc., Syndicate vs. Etherington* (1919), 1 Ch. 306, in respect of excess-profits tax. As to the national income tax, I express no opinion, because after reflection, the whole amount involved is too small to affect results. The point is very perplexing and I am firmly of the opinion that no well-advised employer would use the phrase 'net profits' so that a servant in receipt of commission would be sure of his share of what the agreement called 'profits,' and yet, after paying the so-called income tax, the employer would have no profits left."

It will be noted that following the English decision, the court here is led into the patent error of distinguishing between excess-profits and income tax and also of supposing a case where an employee might receive a share of profits while after paying the tax, nothing would be left to the employer. Of course this is an impossibility, because, as so well stated by the New York court, the bonus of the employee is a deductible expense and the tax can be but a percentage of that portion which remains to the employer.

An analysis of the English decisions will well support the decision of the New York court that the bonus must be figured before income and excess-profits taxes are deducted. What is said in the *Ransome* case (282 Fed. 36) is based upon the decision in the case of *Syndicate vs. Etherington*, Law Reports (1919), 1 Ch. 306. In that case *Etherington* was appointed works manager of the plaintiff corporation, the contract providing for the payment to him of a stipulated sum each year and further "And shall also pay to the works manager at the end of each business year of the company during the continuance of this agreement and within seven days of the holding of the annual general meeting, a further sum by way of commission, such sum to be made up as follows: (1) 5 per cent. upon the net profits for the year (if any) of the said business up to £5,000. (2) 7½ per cent. upon such net profits for the year as exceeds £5,000."

"On June 25, 1918, the company took out this summons to determine whether upon the true construction of the agreement for the purpose of calculating the amount described in clause 5 as 'a further sum by way of commission' and agreed to be paid to the defendant 'at the end of each business year' the 'net profits' referred to in the clause ought to be ascertained (a) after deducting, or (b) without deducting any excess profits duty payable by the plaintiff in or in respect of such year."

Only excess-profits duty and not income tax was involved in this case.

In approaching the decision of this question, the court said (page 309) :

"I would merely by way of introduction to what follows emphasize the fact that the profits with reference to which the duty is, according to the act of 1915, computed, are not, either nominally, or in any sense 'net profits' of a business, the phrase with which we are here concerned. The standard of 'profits' thereby fixed is an arbitrary standard set up by the legislature for the purpose only of the tax and results in a fund which differs both from that represented by the returns of profit for the purpose of income tax, and, in many far-reaching respects alike of omission and addition from the ordinary acceptance of these words."

The court thereupon, while admitting that income tax unquestionably could not be deducted in ascertaining net profits, finds that by reason of the fact that excess-profits tax is levied upon the fund thus arbitrarily fixed and is a debt to the crown payable irrespective of the existence or non-existence of net profits, the deduction is a proper one.

Our American excess-profits tax is levied in a different manner. It and the income tax are both, like the English income tax, levied upon and determined by the net profits of the business after deducting all expenses, including the compensation of employees. So it will be seen that while the English decisions respecting income tax are extremely persuasive in determining the question under consideration, the holdings of their courts respecting the British excess-profits tax cannot be analogous.

In all of the English cases it is conceded that income tax is not deductible before ascertaining profits for the purpose of determining the compensation of an employee. The rule is established in the case of *Attorney General vs. Ashton* (1904), 2 Ch. 624, from which the court in the Etherington case quotes the following language with approval (p. 313) :

"The income tax is a part of the profits—namely, such part as the revenue is entitled to take out of the profits. A sum which is an expense which must be borne whether profits are earned or not may no doubt be deducted before arriving at profit. But a proportionate part of the profits payable to the revenue is not a deduction before arriving at, but a part of the profits themselves."

The same language is also quoted with approval and commented upon in the case of *Johnson vs. Chestergate Hat Manufacturing Co.*, L. R. (1915), 2 Ch. 338. In that case, the manager of the defendant's entire plant was by contract to receive a percentage of the net profits. The contract provided that "net profits" meant the "sum available for dividends." The company contended that it had the right to deduct the income tax from the profits before calculating the manager's percentage. The court rules otherwise, saying :

"The income tax is a part of the profits—namely, such part as the revenue is entitled to take out of the profits. A sum which is an expense which must be borne whether profits are earned or not may no doubt be deducted before arriving at profit. But a proportionate part of the profits payable to the revenue is not a deduction before arriving at, but a part of the profits themselves.' If I were to allow, as the company claims I should allow, the income tax to be deducted before arriving at 'the sum available for dividends,' on which the amount payable to the plaintiff is to be calculated, I should be treating the income tax as an expense payable before the net profits were ascertained, instead of treating it, as I think I must do on the language of the income-tax act, as a part of the net profits themselves."

But there is another class of cases in which the question of "Federal Taxes and Employees' Bonuses" may arise, that is, where the employee receives a per cent. of the net profits of one of several departments of the employer's business. To use my own case as an illustration: The L. & H. Co. operated a coal mine and also did a coal jobbing business. It employed

D as its manager, agreeing that as his compensation he was to receive "25 per cent. of the net profits of the jobbing business." Under this state of facts, D's compensation becomes one of the expenses of the business transacted and it is the balance which becomes a part of the income of the corporation, upon the whole of which the tax is levied. No income or excess-profits tax is levied against the department and the employer is not entitled to charge any portion thereof as an operating expense of that department.

In the case of *Thomas vs. Hamlyn*, L. R. (1917), 1 King's Bench, 527, the plaintiff, an employee, was to receive as compensation a percentage of the net profits of four of the numerous branches of the employer's business. The employer admitted that it had no right to a deduction on account of income tax, but claimed the right to deduct a proportion of the excess-profits tax paid by it. This right was denied by the court, saying:

"I think, therefore, that upon the broad question the plaintiff is right. Further, when we consider this particular agreement, the plaintiff is clearly right upon another ground. This business has numerous branches and the plaintiff is concerned only with four of them, and he is entitled to a percentage upon the net profits of those four branches when taken together. There is no excess-profits duty in respect to any particular branch; it is a tax upon the business as a whole. Therefore, under this agreement, there cannot be any question of deducting excess-profits duty."

A consideration of this situation must of necessity answer the question. Suppose the jobbing business made a profit, but the mine suffered an equal loss. The corporation pays no tax. Is the employee relieved of the deduction by reason of a loss in a department in which he has no interest? On the other hand, suppose the jobbing business made a reasonable profit, while the mining business prospered to such an extent that the corporation pays a tax amounting to approximately forty per cent. of its total net profits. Is the employee to suffer a deduction by reason of a prosperity in which he is precluded from sharing?

D's compensation, being based upon the net profits of certain transactions, those transactions alone must be considered in determining its amount. This has been decided in both the United States and in England. In the case of *Stilphen vs. Elliott*, 173 Pac. Rept. 700, the supreme court of Utah held:

"The term 'net profits' in a contract providing plaintiff should receive ten per cent. of the net profits accruing on any business he closed for the defendant company, means the 'net profits' on contracts or work plaintiff obtained, and the expenses of operating defendant's business must not be considered in determining compensation."

In the case of *British Columbia Spar Company*, in re Stamp Claim, 25 Law Times (N. S.), 653, the Vice-chancellor held that where the remuneration of the manager of a company was a moiety of only a portion of the company's business, only the expenses necessary on account of that particular portion are deductible in calculating the moiety and none of the general expenses of the company are deductible.

I submit, therefore, that both upon authority and sound reason, the question asked by G. J. P. of Walla Walla, Washington, in your issue of December, 1922, must be answered that the tax paid is not a fair charge against the departments for the purpose of determining the salary of the employee.

Yours very truly,
Kansas City, Missouri, November 20, 1923. CALEB S. MONROE.

Scovell, Wellington & Co. announce the removal of their Chicago office to the London Guarantee & Accident building, 360 North Michigan avenue, at the Michigan boulevard bridge.