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Students' Department

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AMERICAN INSTITUTE OF ACCOUNTANTS

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

MAY 16, 1924, 1 P. M. TO 6 P. M.

The candidate must answer all the following questions:

No. 1 (27 points):

Drafts of the profit-and-loss accounts and the balance-sheet of the Atlantic Trading Company, showing the results of operations for the year ended December 31, 1923, were prepared for submission to the directors in January, 1924.

Before they were approved, a report of an investigation of the accounts of the company for the years 1919, 1920 and 1921 was received from the internal-revenue department. This report reduced considerably the large amounts of depreciation written off various assets and made a claim for the difference as additional excess profits and income taxes.

The claim was subsequently paid, and the directors decided to have the accounts for the years 1922 and 1923 and the balance-sheets at the end of those years redrafted in order to bring them into agreement with the figures shown in the internal-revenue report.

The accounts on the books of the company appear as follows:

Property Accounts 1922	Valuation Jan. 1	Additions during year	Depreciation Dec. 31	Balance forward
Real estate	$200,503.79	$2,249.08*	$10,162.61	$192,590.26
Machinery and tools	2,206.95	1,799.01	1,918.07	2,087.89
Auto trucks	21,521.06	31,000.48	12,360.08	40,161.46
Horse trucks	132.50		132.50	
Horses	800.00	575.00	583.34	791.66
Harness	245.70	61.05	221.75	85.00
Office furniture	1,774.42	2,909.86	1,610.59	3,073.69
	$227,184.42	$38,594.48	$26,988.94	$238,789.96

Property Accounts 1923	Valuation Jan. 1	Additions during year	Depreciation Dec. 31	Balance forward
Real estate	$192,590.26	$210.00*	$3,300.26	$189,500.00
Machinery and tools	2,087.89	1,235.38	1,755.73	1,567.54
Auto trucks	40,161.46	8,782.41	17,134.84	31,809.03
Horse trucks		112.58	66.92	45.66
Horses	791.66	700.00	741.67	749.99
Harness	85.00	80.00	143.00	22.00
Office furniture	3,073.69	3,264.54	3,400.86	2,937.37
	$238,789.96	$14,384.91	$26,543.28	$226,631.59

* The additions to real estate in 1922 and 1923 apply to sheds.

The internal-revenue agents traced back the original costs of the assets and all additions. Against these total costs they created depreciation reserves at the rates shown below.

You are required to take their figures as at the date to which their examination was restricted (December 31, 1921) and to extend them further, on the same basis, to December 31, 1923. Then bring the amounts of total cost into the accounts of the company, create the necessary reserves for depreciation and state the adjustments required in the profit-and-loss accounts, surplus account and balance-sheets at December 31, 1922 and 1923, in order to show the effect of these changes.

The amounts of additions to the assets, stated in the books of the company for the years 1922 and 1923, are to be taken as correct.

Note that the item of real estate has been divided, by the internal-revenue agents, into three separate classes to show different rates of depreciation.

Summary of Report of Internal-Revenue Department Agents

	Total cost to Jan. 1, 1922	Depreciation reserve Jan. 1, 1922	Annual rate of depreciation allowed
Real estate (see below):			
Machinery and tools	$ 8,701.97	$ 4,306.77	20 %
Auto trucks	72,297.42	37,429.11	20 %
Horse trucks	1,691.63	680.39	$16\frac{2}{3}$%
Horses	5,788.17	2,873.07	20 %
Harness	1,444.59	1,116.92	$33\frac{1}{3}$%
Office furniture	5,576.92	1,311.03	10 %
Land (Real estate)	164,364.60	(none)	(none)
Sheds (Real estate)	9,581.14	1,578.11	10 %
Brick buildings (Real estate)	39,596.93	2,143.88	2 %
		$51,439.28	
Depreciation reserve (not allocated to specific assets) for period prior to Jan. 1, 1919		12,718.36	
	$309,043.37	$64,157.64	

Solution:

The first step is to determine the adjusted values of the property, setting up the total costs in asset accounts and setting up the reserves against them. There does not seem to be any way of apportioning the unallocated reserve over the various classes of assets, as there is no information as to the dates of acquisition of the property.

ADJUSTMENT OF PROPERTY ACCOUNTS

As of January 1, 1922

	Valuation per books	Corrected valuations Total cost	Depreciation reserve	Net value
Real estate...........	$200,503.79			
Land............		$164,364.60		$164,364.60
Sheds............		9,581.14	$1,578.11	8,003.03
Brick buildings....		39,596.93	2,143.88	37,453.05
Machinery and tools...	2,206.95	8,701.97	4,306.77	4,395.20
Auto trucks..........	21,521.06	72,297.42	37,429.11	34,868.31
Horse trucks..........	132.50	1,691.63	680.39	1,011.24
Horses...............	800.00	5,788.17	2,873.07	2,915.10
Harness..............	245.70	1,444.59	1,116.92	327.67
Office furniture........	1,774.42	5,576.92	1,311.03	4,265.89
Depreciation reserve (not allocated to specific assets) for period prior to January 1, 1919..............			12,718.36	12,718.36*
Total........	$227,184.42	$309,043.37	$64,157.64	$244,885.73
Adjustments as of January 1, 1922:				
Property account before adjustment		227,184.42		
Debit to property account........		$81,858.95		
Reserves for depreciation — before adjustment.....				
Credits to reserves			$64,157.64	
Net value of property before adjustment.......				227,184.42
Credit to surplus..				$17,701.31

The problem indicates that the property accounts have already been adjusted as of January 1, 1922, and that adjustments have also been made in regard to the taxes, as the problem states that the taxes were paid. In computing the depreciation for 1922 and 1923 on the adjusted basis, it is necessary to take precautions against over-depreciating any asset. By reference to the following schedule, it will be noted that depreciation of only $327.67 was provided on the harness acquired prior to January 1, 1922. Depreciation at the rate of 33⅓% would have amounted to $481.53, which would have over-depreciated the property.

* Deduction.

ADJUSTMENT OF PROPERTY AND OTHER ACCOUNTS
As of December 31, 1922

	(1) Depreciation rate	(2) Total cost to Jan. 1, 1922	(3) Depreciation thereon for 1922	(4) Depreciation prior to 1922	(5) Total reserve against assets acquired prior to 1922
Real estate:					
Land		$164,364.60			
Sheds	10%	9,581.14	$958.11	$1,578.11	$2,536.22
Brick buildings	2	39,596.93	791.94	2,143.88	2,935.82
Machinery and tools	20	8,701.97	1,740.39	4,306.77	6,047.16
Auto trucks	20	72,297.42	14,459.48	37,429.11	51,888.59
Horse trucks	16⅔	1,691.63	281.94	680.39	962.33
Horses	20	5,788.17	1,157.63	2,873.07	4,030.70
Harness	33⅓	1,444.59	327.67	1,116.92	1,444.59
Office furniture	10	5,576.92	557.69	1,311.03	1,868.72
Unallocated reserve				12,718.36	12,718.36
		$309,043.37	$20,274.85	$64,157.64	$84,432.49

	(6) Cost of property acquired during 1922	(7) Depreciation one half year	(8) Total property (2+6)	(9) Total reserve (5+7)
Real estate:				
Land			$164,364.60	
Sheds	$2,249.08	$112.45	11,830.22	$2,648.67
Brick buildings			39,596.93	2,935.82
Machinery and tools	1,799.01	179.90	10,500.98	6,227.06
Auto trucks	31,000.48	3,100.05	103,297.90	54,988.64
Horse trucks			1,691.63	962.33
Horses	575.00	57.50	6,363.17	4,088.20
Harness	61.05	10.18	1,505.64	1,454.77
Office furniture	2,909.86	145.49	8,486.78	2,014.21
Unallocated reserve				12,718.36
	$38,594.48	$3,605.57	$347,637.85	$88,038.06

Property account:		
Total cost (per column 8)		$347,637.85
Property account per books (as stated in problem)		238,789.96
Addition to property account		$108,847.89
Consisting of:		
Correction as of January 1, 1922	$81,858.95	
Depreciation written off in 1922	26,988.94	
Total	$108,847.89	
Reserves for depreciation—total credit (column 9)		$88,038.06

Consisting of:		
Reserve as of January 1, 1922		$64,157.64
Depreciation for 1922:		
On assets acquired prior to 1922	$20,274.85	
On assets acquired during 1922	3,605.57	23,880.42
Total		$88,038.06

Decrease of depreciation and increase of profits of 1922:	
Depreciation provided per books	$26,988.94
Adjusted amount provided	23,880.42
Decrease in depreciation and increase in profits	$3,108.52

Additional federal taxes:	
12½% of additional profits of $3,108.52	$388.57

Surplus:		
Addition to property	$108,847.89	
Less addition to reserve	88,038.06	
		$20,809.83
Less additional taxes		388.57
Net addition to surplus		$20,421.26

Summary of additions to balance-sheet items
As of December 31, 1922

Property account	$108,847.89	Reserves for depreciation	$88,038.06
		Additional tax liability	388.57
		Surplus	20,421.26
	$108,847.89		$108,847.89

The following tabulation continues the computations and shows the values at the end of 1923, after adjustments:

Adjustment of Property and Other Accounts
As of December 31, 1923

	(1) Depreciation rates	(2) Total cost to January 1, 1922	(3) Reserve to Dec. 31, 1922	(4) Depreciation thereon for 1923
Real estate:				
Land		$164,364.60		
Sheds	10%	9,581.14	$2,536.22	$958.11
Brick buildings	2	39,596.93	2,935.82	791.94
Machinery and tools	20	8,701.97	6,047.16	1,740.39
Auto trucks	20	72,297.42	51,888.59	14,459.48
Horse trucks	16⅔	1,691.63	962.33	281.94
Horses	20	5,788.17	4,030.70	1,157.63
Harness	33⅓	1,444.59	1,444.59	
Office furniture	10	5,576.92	1,868.72	557.69
Unallocated reserve			12,718.36	
		$309,043.37	$84,432.49	$19,947.18

	(5) Total reserve thereon (3+4)	(6) Additions 1922	(7) Depreciation thereon for 1922	(8) Depreciation thereon for 1923
Real estate:				
Land				
Sheds	$3,494.33	$2,249.08	$112.45	$224.91
Brick buildings	3,727.76			
Machinery and tools	7,787.55	1,799.01	179.90	359.80
Auto trucks	66,348.07	31,000.48	3,100.05	6,200.10
Horse trucks	1,244.27			
Horses	5,188.33	575.00	57.50	115.00
Harness	1,444.59	61.05	10.18	20.35
Office furniture	2,426.41	2,909.86	145.49	290.99
Unallocated reserve	12,718.36			
	$104,379.67	$38,594.48	$3,605.57	$7,211.15

	(9) Additions 1923	(10) Depreciation thereon for 1923	(11) Total property (2+6+9)	(12) Total reserve (5+7+8+10)
Real estate:				
Land			$164,364.60	
Sheds	$210.00	$10.50	12,040.22	$3,842.19
Brick buildings			39,596.93	3,727.76
Machinery and tools	1,235.38	123.54	11,736.36	8,450.79
Auto trucks	8,782.41	878.24	112,080.31	76,526.46
Horse trucks	112.58	9.38	1,804.21	1,253.65
Horses	700.00	70.00	7,063.17	5,430.83
Harness	80.00	13.33	1,585.64	1,488.45
Office furniture	3,264.54	163.23	11,751.32	3,026.12
Unallocated reserve				12,718.36
	$14,384.91	$1,268.22	$362,022.76	$116,464.61

Property account:		
Total cost (per column 11)		$362,022.76
Property account per books (per problem)		226,631.59
Addition to property account		$135,391.17
Consisting of:		
Correction as of December 31, 1922	$108,847.89	
Depreciation written off in 1923	26,543.28	
Total	$135,391.17	
Reserves for depreciation—Total (per column 12)		$116,464.61
Consisting of:		
Reserves as of December 31, 1922		$88,038.06
Depreciation for 1923:		
On assets acquired prior to January 1, 1922	$19,947.18	
On assets acquired during 1922	7,211.15	
On assets acquired during 1923	1,268.22	28,426.55
Total		$116,464.61

Increase of depreciation and decrease of profits for 1923:	
Adjusted depreciation	$28,426.55
Depreciation per books	26,543.28
Decrease in depreciation and increase in profits	$1,883.27
Reduction of taxes—12½% of $1,883.27	$235.41
Surplus:	
Addition as of December 31, 1922	$20,421.26
Addition on account of decrease in taxes—1923	235.41
Total	$20,656.67
Less additional depreciation—1923	1,883.27
Net increase in surplus as of December 31, 1923	$18,773.40

Summary of additions to balance-sheet items

As of December 31, 1923

Property	$135,391.17	Reserves for depreciation	$116,464.61
Claim for overpayment of 1923 federal taxes	235.41	Additional tax liability—1922	388.57
		Surplus	18,773.40
	$135,626.58		$135,626.58

No. 2 (10 points):

A certain manufacturing concern makes tools and other equipment for use in its own plant and charges them to the capital asset accounts at the market value (which is in excess of cost) and credits the difference between the market and the cost value to profit-and-loss for the period in which the tools and other equipment are manufactured.

In the examination of the customers' accounts of this concern, you find certain credit balances aggregating $13,011.31 arising out of allowances for returned goods, defective goods, etc. It has been the practice of the company to deduct items of this nature from amounts due from customers and to state the net difference in the balance-sheet as "uncollected customers' accounts."

What is your criticism of these methods?

Solution:

The practice of charging the property accounts with the market value of tools and other equipment manufactured, such market value being in excess of cost, and crediting the excess over cost to profit-and-loss for the period, is subject to two criticisms. In the first place, it results in carrying fixed assets in the accounts at a value greater than cost, which is incorrect in itself and results in the further error of making the depreciation charges of subsequent periods too heavy. In the second place, it results in taking up a profit which has not been realized. Profits are made by sales, and not by manufacturing fixed assets for use in further production. The manufacture of the tools and equipment has evidently resulted in a saving, but savings should not be recorded as profits. Since credit balances in accounts receivable are liabilities, they should be set out on the liability side of the balance-sheet, and the debit side should show accounts receivable at the total of the debit balances in the subsidiary ledger.

No. 3 (23 points):

The following is a summary of the cash receipts and disbursements of the trustees of the late R. A. Armstrong and a distribution of the estate.

Under the terms of his will, Mr. Armstrong left all his estate in trust for his two children with the exception of his life insurance of $500,000 and his home, valued at $100,000, which he bequeathed to his widow, an annuity to his sister and sundry legacies. The income from the estate he instructed the trustees to pay to his widow during her life.

Receipts:

Cash and bank balances at date of death	$50,000
Life insurance	500,000
Income from bond interest	5,000
Income from dividends on stock	10,000
Income from dry-goods business, net	500,000
Sundry debtors at date of death	15,000
Proceeds of sale of dry-goods business, including new buildings and equipment	5,500,000
Securities sold, stocks and shares	1,000,000
Securities sold, bonds and debentures	500,000
	$8,080,000

Disbursements:

Sundry creditors at date of death	$5,000
Inheritance tax	800,000
Sundry legacies paid in full	300,000
Mrs. Armstrong, net income	300,000
Advances to heirs ($100,000 each)	200,000
Legal expenses	400,000
Funeral expenses	15,000
Cost of constructing extension, dry-goods store	700,000
Cost of annuity for Miss Armstrong, deceased's sister	500,000
	$3,220,000

Balance, being net amount of estate to be divided equally between the two children $4,860,000

From the figures and information given above, you are asked to prepare correct capital and revenue accounts and state the balance due to the widow and each of the children. (Consider that the widow should receive all the income collected.)

Solution:

In order to maintain a proper distinction between principal and income, the cash account should have been provided with classification columns as follows:

Cash receipts	Principal	Income	Total
Cash and bank balances at time of death	$50,000		$50,000
Life insurance	500,000		500,000
Income from bond interest		$5,000	5,000
Income from dividends on stock		10,000	10,000
Income from dry-goods business—net		500,000	500,000
Sundry debtors at date of death	15,000		15,000
Proceeds of sale of dry-goods business	5,500,000		5,500,000
Securities sold, stocks and shares	1,000,000		1,000,000
Securities sold, bonds and debentures	500,000		500,000
	$7,565,000	$515,000	$8,080,000

Cash disbursements			
Sundry creditors at date of death	$ 5,000		$ 5,000
Inheritance tax	800,000		800,000
Sundry legacies	300,000		300,000
Mrs. Armstrong—net income		$300,000	300,000
Advances to heirs	200,000		200,000
Legal expenses	400,000		400,000
Funeral expenses	15,000		15,000
Cost of extension, dry-goods store	700,000		700,000
Cost of annuity for Miss Armstrong	500,000		500,000
Balance	4,645,000	215,000	4,860,000
	$7,565,000	$515,000	$8,080,000

The problem specifically states that the bond interest and the dividends were income. It is unusual to find an estate with no interest accrued at the date of death, and with no dividends declared at that time. In classifying the income from the dry-goods business as "income" it is necessary to assume that the wording of the problem is final and that the books were closed at date of death. There is no basis for dividing the legal expenses between principal and income, as there is no information as to the amount incurred in preserving and realizing the estate and the amount incurred in collection of income. There is no evidence to indicate that the trustees had any right to make advances to the heirs.

It may be impossible to prepare an absolutely correct capital account from the information given. The estate, or capital, account should be credited with the inventoried value of the property at the time of death; subsequent gains and losses on realization should be credited and charged to the account. But this information is not given. The income account would be credited with the items in the income column of the cash receipts record, and charged with the items in the income column of the cash disbursements record. The table, as prepared, shows that Mrs. Armstrong has not received the net income but is entitled to an additional payment of $215,000.

No. 4 (23 points):

You are instructed to investigate the financial condition of a concern by a client who is a large creditor. He informs you that the company about to be investigated has been falling behind in payments and believes that this is caused by a too extensive application of funds, or use of working capital, for the construction of new plants, etc. He furnishes you with a statement supplied by an officer of the company as at the beginning of the year, on the basis of which credit was granted, and requests that you make a report on the financial standing of the concern at the end of the year and on the situation in general.

You find that the company has no general ledger, but that a cashbook, sales book, voucher register and accounts-receivable ledger are kept. You list the assets and liabilities, with the exception of the plant (of the cost of which there is no record in evidence), and obtain the following result of conditions as at the end of the year:

Cash	$ 5,000	Bank loans	$ 14,000
Accounts receivable	24,000	Notes payable	20,000
Inventories	18,000	Vouchers payable	75,000
Sundry assets	4,000	Mortgages payable	10,000
Total assets, excepting plant	$51,000	Total liabilities, excepting capital	$119,000

The balance-sheet, presented by the officer representing the company, at the beginning of the year was as follows:

Cash	$ 40,000	Bank loans	$ 10,000
Accounts receivable	38,000	Notes payable	15,000
Inventories	20,000	Vouchers payable	60,000
Sundry assets	4,000	Mortgages payable	10,000
Plant	250,000	Capital stock	50,000
		Surplus	207,000
	$352,000		$352,000

An analysis of the books of original entry for the year furnished the following summarized results:

Cashbook receipts:		
Cash	$852,500	
Discount	7,500	
To accounts receivable		$850,000
Bank loans		10,000
Cashbook disbursements:		
Vouchers payable	838,500	
Bank loans payable	16,000	
To cash		854,000
Discount		500
Sales book:		
Accounts receivable	852,000	
To sales		852,000
Voucher register:		
New construction	25,000	
Operating expenses	798,000	
To vouchers payable		823,000

From trustworthy information, it was gathered that the inventories had decreased $5,000 during the year.

Having completed your investigation and reached conclusions for the purpose intended, what will be the report to your client?

Solution.

The report might begin with a comparative statement of assets and liabilities, showing the condition at the beginning and at the end of the year. The statement as of the beginning of the year would show the figures submitted by the officer of the company, with a comment as to the source of the information. In the following statement the plant value as of the beginning of the year has been added to the expenditures for plant made during the year, but the report should contain a qualification disclaiming responsibility for the $250,000 value.

Name of Company

Comparative Balance-Sheet—Dates

Assets	End	Beginning	Increase Decrease*
Cash	$ 5,000	$ 40,000	$35,000*
Accounts receivable	24,000	38,000	14,000*
Inventories	18,000	20,000	2,000*
Sundry assets	4,000	4,000	
Plant:			
Value at beginning of year	250,000	250,000	
Additions during year	25,000		25,000
	$326,000	$352,000	$26,000*

Liabilities			
Bank loans	$14,000	$10,000	$4,000
Notes payable	20,000	15,000	5,000
Vouchers payable	75,000	60,000	15,000
Mortgages payable	10,000	10,000	
Capital stock (presumably no change)	50,000	50,000	
Surplus	157,000	207,000	50,000*
	$326,000	$352,000	$26,000*

The summary of the entries for the year indicates that the assets and liabilities shown in the statement furnished by the officer of the company as of the beginning of the year were misstated, because the changes in assets and liabilities shown in the increase-decrease column of the foregoing comparative statement do not agree with the changes shown by the books of original entry, as summarized below:

Cash:		
Disbursements		$854,000
Receipts		852,500
Net decrease		$1,500
Accounts receivable:		
Charges for sales		$852,000
Credits:		
Cash	$842,500	
Discount	7,500	850,000
Net increase		$2,000
Bank loans:		
Cash paid during the year		$16,000
Cash received during the year		10,000
Net decrease		$6,000
Vouchers payable:		
Charges during the year:		
Cash	$838,000	
Discount	500	
		$838,500
Credits during the year:		
New construction	25,000	
Operating expenses	798,000	823,000
Net decrease		$15,500

Assuming that the balance-sheet at the end of the year and the entries during the year have been verified by audit, the balance-sheet at the beginning of the year can be built up by applying to the closing balance-sheet the increases and decreases shown by the books of original entry. The following statement shows the balance-sheet submitted by the officer and the balance-sheet built up by the method suggested. There is no indicated change in the notes payable. The inventory has decreased $5,000.

NAME OF COMPANY

Comparative Balance-Sheet

Assets	End	Increase Decrease*	*Beginning* Adjusted	Per officer
Cash	$5,000	$1,500*	$6,500	$40,000
Accounts receivable	24,000	2,000	22,000	38,000
Inventories	18,000	5,000*	23,000	20,000
Sundry assets	4,000		4,000	4,000
Plant (assuming accuracy of $250,000)	275,000	25,000	250,000	250,000
	$326,000	$20,500	$305,500	$352,000
Liabilities				
Bank loans	$14,000	$6,000*	$20,000	$10,000
Notes payable	20,000		20,000	15,000
Vouchers payable	75,000	15,500*	90,500	60,000
Mortgages payable	10,000		10,000	10,000
Capital stock	50,000		50,000	50,000
Surplus	157,000	42,000	115,000	207,000
	$326,000	$20,500	$305,500	$352,000

The increase in surplus during the year, in the amount of $42,000, is supported and accounted for by the following statement:

Name of company

Profit and loss account

For the year ended ——

Inventory at beginning	$23,000	Sales	$852,000
Operating expenses	798,000	Discounts taken	500
Discounts allowed	7,500	Inventory at end	18,000
Profit	42,000		
	$870,500		$870,500

The reasons for the company's inability to meet its payments may be further explained by the following statement:

Name of company

Statement of application of funds

For the year ended ——

Funds provided:		
By profits		$42,000.00
By net decrease in current assets:		
Decrease in cash	$1,500.00	
Decrease in inventories	5,000.00	
Total	$6,500.00	
Increase in accounts receivable	2,000.00	
		4,500.00
		$46,500.00

Funds applied:

Additions to plant		$25,000.00
Decreases in current liabilities:		
Bank loans	$6,000.00	
Vouchers payable	15,500.00	
		21,500.00
		$46,500.00

No. 5 (17 points):

The following propositions are presented:

1. Depreciation of physical property is continuous and unavoidable.
2. Interest on invested capital is an element of cost.
3. Cash is a current asset.
4. True value of inventories is cost or market, whichever is lower.
5. True value of fixed assets on the books of a going concern is replacement value.
6. Interest paid previous to operation of a new plant is part of cost of plant.
7. Dividends on stocks accrue day by day.
8. Inter-company profits belonging to minority stockholders have no place in a consolidated balance-sheet.

Without copying or discussing the foregoing propositions at any length, indicate to which of the categories following they belong:

A. Statements of incontrovertible fact, or
B. Statements which are not strictly true.
C. Statements of accepted accounting principle or procedure which are correct, or
D. Statements of accepted accounting principle or procedure which are incorrect, or
E. Controversial statements of accounting principle or procedure for which reputable authority may be found on both sides.

Solution:

(1) Statement of incontrovertible fact.

(2) Controversial statement.

(3) Statement of incontrovertible fact so far as unrestricted cash is concerned. Cash in sinking fund is not current.

(4) Until recently this statement would have been considered an expression of accepted accounting principle which was regarded as correct. Other propositions have been submitted by competent authorities recently which perhaps put the statement in the controversial class.

(5) This is a statement which is not strictly true. Replacement value is perhaps not true value, but most accountants recognize the propriety of reflecting replacement value in the accounts if proper treatment is given to the unrealized profit resulting from revaluing the property.

(6) This statement is not strictly true. The interest is not in reality a part of the cost, but the capitalization of the interest is permitted because of the fact that before a new plant is put into operation it produces no profits against which the interest can be charged.

(7) This statement is not legally true. Dividends do not accrue. But since the so-called accrual of dividends is taken into account in the purchase and sale of stock it can scarcely be denied that the passing of time tends to add a value to the stock. Perhaps the best statement is: It is unfortunate that there is no other word which expresses the real meaning which "accrual" is called upon to express.

(8) This is a controversial question. Some accountants believe that the entire inter-company profit should be eliminated; others believe that only the holding company's proportion should be eliminated.

Reserves for Contingencies

Editor, Students' Department:

SIR: On the books of a partnership there appears at the end of three years the following account: "Reserve for possible losses of perishable merchandise, $4,500." The partnership was formed by A, B and C, who share profits and losses equally.

The partnership agreement states that goodwill shall be considered as an amount equal to the net earnings for the last two years. At the end of the third year A desires to retire from the partnership. The reserve was created out of the profits of the two previous years, and at the time of A's retirement it is apparent that the reserve has not been needed as no losses of merchandise have occurred. Is the retiring partner entitled to a share of the reserve?

S. D. G.

Rio Piedras, Porto Rico.

The retiring partner is entitled to share in the reserve. It is not proper to deduct from the profits of the three years during which he was a partner a provision for a loss which has not occurred during the period of his membership in the firm. If any merchandise on hand at the time of his retirement is in bad condition, the loss should be charged against the reserve. The question seems to mean that the merchandise is in good condition.

A will share in the reserve in two ways. In the first place, since profits and losses are shared equally, he will be entitled to a credit of one-third of the amount of the reserve as his share of the profits which have been set aside in a contingent reserve which proved to be unnecessary. In the second place, the reserve will have to be added back to the profits of the past two years to determine the total profits on which the good-will is based. This will result in an increase of $4,500 in the good-will and, as good-will is divisible in the profit and loss ratio, A will be entitled to one-third of the good-will.

Thus A will receive an additional credit of $1,500 as his share of the profits set aside in the reserve and an additional $1,500 as his share of the increase in the good-will.

Consignments and Bonus

Editor, Students' Department:

SIR: An employee is entitled to a commission or bonus of two and one-half per cent of the annual net profits. He leaves the firm on April 1, 1924. The profit for 1923 was say $20,000. Goods shipped during 1923 on consignment and billed at regular prices, to be accounted and paid for when sold, amounted to say $15,000. These goods were taken into the inventory at December 31, 1923, at cost.

Is the employee entitled to two and one-half per cent on the earnings from consignments shipped during 1923 and collected up to April 1, 1924?

Very truly yours,

F. C. A.

New York.

In answering this question it must first be known whether the employee is to be allowed a commission on the profits earned between December 31, 1923 and April 1, 1924. If he is to be allowed such a commission, it would seem that he should be allowed the two and one-half per cent on the profits earned on consignments closed during the three months.

But if he is not to receive any bonus on the 1924 profits, it seems equally clear that he is not entitled to any bonus on consignments shipped during 1923 but not sold by consignees until 1924. The principle is well established that profits are earned by sales and no profit is made by merely shipping goods on consignment. Therefore, the shipments which took place in 1923 produced no profit during that year unless they were closed during the year; the profits on consignments closed during 1924 belong to 1924.

On the other hand the employee would have the right to demand that all expenses in connection with these consignments be deferred until 1924, as it is not proper for him to suffer by the incurring of expenses if he is not allowed to benefit by profits. It may also be possible that the employee is entitled to some special consideration because of the fact that he devoted time and labor to inducing consignees to take the goods.

Partnership Adjustment

Editor, Students' Department:

SIR: Through the columns of THE JOURNAL OF ACCOUNTANCY, kindly give me your opinion of the solutions of the following problems, and if both are incorrect, will you please give me the proper one?

"A and B are partners sharing profits in accordance with their original investments. A invested $5,000 and B $3,000, making the capital of the firm $8,000. They sell a one-third interest in the business to C for $8,000. How shall A and B divide the $8,000 received from C so that each may retain a one-third interest in the business without increasing or decreasing the original capital of the firm?"

Solution No. 1:

A owns 5/8 or 15/24 of the business.
B owns 3/8 or 9/24 of the business.
A retains 1/3 or 8/24 of the business, therefore A contributes to C's share with 7/24 (15/24 less 8/24).
B retains 1/3 or 8/24 of the business, therefore B contributes to C's share with 1/24 (9/24 less 8/24).
Now if C pays $8,000 for 8/24 of the business, he pays $1,000 for 1/24.

If A contributes 7/24 he will receive	$7,000
If B contributes 1/24 he will receive	1,000
Total	$8,000

Solution No. 2.

	A	B	C	Total
Original capital	$5,000.00	$3,000.00		$8,000.00
A's contribution to C's share: 5/8 of 1/3, or 5/24 of $8,000	1,666.67		$1,666.67	
B's contribution to C's share: 3/8 of 1/3, or 3/24 of $8,000		1,000.00	1,000.00	
Capitals after contributions	$3,333.33	$2,000.00	$3,666.57	$8,000.00
A's contribution to equalize B's capital	666.66	666.66		
New capitals	$2,666.67	$2,666.66	$2,666.67	$8,000.00

A's share in the $8,000 contributed by C is:

5/8 of $8,000, or	$5,000.00
Capital contributed to B	666.66
Total amount to be received in cash	$5,666.66

B's share in the $8,000 contributed by C is:	
3/8 of $8,000, or	$3,000.00
Capital repaid to A	666.66
Total amount to be received in cash	$2,333.34

Thanking you in advance for your courtesy, I remain,

Yours very truly,
S. G. Ramirez.

San Juan, Porto Rico.

The price received from C should be divided into two parts: first, the compensation for the interests transferred, and secondly, the profit. The first portion should be divided on the basis of the interests transferred and the second portion should be divided in the profit and loss ratio. The profit and loss ratio governs the division of the profit on a sale of an interest, because the partners are taking an immediate profit instead of waiting to take it from operations. In other words, they are allowing a third partner a share in the profits. This will decrease the profits to be shared in the future by the original partners. Therefore the profit on the sale should be divided in the ratio which would have governed the division of the profits parted with.

The first solution is therefore wrong because it divided the entire price on the basis of the interests transferred. The second solution is correct, but it is not tabulated in what appears to be a clear manner. The following statement of facts is suggested:

Statement of Division Between A and B of Cash Received from C

		A	*B*	*Total*
Original capitals		$5,000.00	$3,000.00	$8,000.00
Less capitals retained—1/3 of $8,000.00		2,666.67	2,666.67	5,333.34
Cash to be received for capital interests transferred		$2,333.33	$333.33	$2,666.66
Cash to be received for profit on transfer:				
Total amount received	$8,000.00			
Total capital transferred	2,666.66			
Profit	5,333.34			
Divided in the profit and loss ratio:				
A—5/8 of $5,333.34		3,333.34		
B—3/8 of 5,333.34			2,000.00	
Total				5,333.34
Total cash to be received		$6,666.67	$2,333.33	$8,000.00