Students' Department

EDITED BY H. A. FINNEY.

FEDERAL TAXES AND EMPLOYEE'S BONUS.

When an employee is allowed a bonus based on the net profits, the question whether or not federal taxes are to be considered an expense to be deducted before determining the net profits subject to the bonus should be considered at the time of making the contract, and a provision dealing with that question should be inserted in the contract. If such a clause is not inserted in the contract the question will come up when the bonus is to be computed; the company will claim that the tax should be deducted as an expense, the employee will claim that the tax should not be deducted, and the dispute will be on.

The dispute may be arbitrarily settled, compromised or referred to some one for arbitration. So far as I know, the person who arbitrates the dispute will have to decide the question on the basis of his own opinion. At least, I know of no legal ruling which can be considered absolute and final authority. If there is such a ruling I hope that some one who reads this will know about it and will refer me to it so that the information can be published in a subsequent issue.

In the July, 1922, *Students' Department,* the question of taxes and bonus was put by a reader as follows:

Editor, Students' Department:

Sir: "A" was the manager of several departments in a store and had an oral agreement with the president that in addition to his salary he was to get 10% of the profit of those departments. No data are available to show if there was any other qualifying condition as to how the profit was to be figured. Now the corporation submits him a statement giving the results of the year's business and in this statement his departments have been charged with a proportion of income tax paid to the government. Now the question in my mind is whether this tax paid to the government is a fair charge against his departments or if it is proper to charge it against surplus, pure and simple. Just what would be the correct way to treat this item, and what is the usual way of handling it?

Very truly yours,

G. J. P.

Walla Walla, Washington.

The published reply to this letter was:

"A is to receive a percentage of the net profits; the net profits are not known until all expenses have been deducted; taxes are an expense; therefore it is the opinion of this department that it is proper to deduct a portion of the income tax from the profits of the departments in which the manager was interested. The mere fact that the expense of taxes is computed on the basis of profits before deducting taxes does not change the fact that the taxes are an expense.

"Since the tax is based on profits, the proper way to apportion the tax among the several departments is on the basis of the profits of the departments."

This letter and the reply to it, brought a letter from C. F. Seeger, of Atlanta, Georgia, expressing a disagreement with the opinion stated. Before quoting the correspondence with Mr. Seeger I should like to elaborate the theory underlying my opinion.

Either the income tax is an expense or it is a division of profits. If it is an expense it is deductible in determining the net profit; if it is a division of profits it is not deductible. Which is it?

First, is it a division of profit? The word "profit" is defined in Webster's dictionary as "the advantage or gain resulting to the owner of capital from its employment in any undertaking," and this definition is in accord with the business conception of profits. Profits belong to the proprietor, partners or stockholders, and only the owners share in the distribution of profits. Taxes may be based on profits or, as is actually the case, on a concept of the law known as taxable net income; but the taxes paid to the government are not a distribution of the profits of the business, because the government is not a stockholder. The tax is a payment made by the business to the government for governmental benefits. Since it is a payment by the business for benefits received by the business it is an expense, and the profits of the business are not known until expenses have all been deducted and gross profits reduced to the figure remaining for distribution among the stockholders.

Incidentally, it may be noted that this reasoning can be applied with equal force to support an argument that the bonus itself should be considered an expense before determining the profits subject to the bonus; in other words that the computation of the bonus should be made by dividing by 100% plus the bonus rate instead of multiplying by the bonus rate. But this is not the point at issue here.

The question and answer quoted above, brought the following letter from Mr. Seeger:

Editor, Students' Department:

Sir: On page 65 of the July issue a question in reference to the effect of federal taxes upon bonus is considered, and I note that you take the position that federal taxes are an expense and therefore deductible in determining the manager's bonus under the agreement set forth in the question.

If my memory serves me correctly in several decisions the courts have criticized very harshly any attempt to consider federal taxes based upon profits as an expense. The writer concurs with you to the extent of the accounting theory involved, but it is possible to view the position taken by the federal courts that under the contract outlined in the question the manager was legally entitled to his bonus based upon the profits without regard to the amount of federal taxes paid.

Unquestionably there are many legal phases of the federal tax laws which run contrary to good accounting principles; nevertheless we must observe court rulings when any contract is in dispute. Irrespective of what we may think or believe, good accounting requires a strict compliance with the legal status of a contract and the best we can do when the legal status conflicts with our theory is to disregard the theory and comply with the construction which would probably be placed upon a contract by the courts.

I am not unmindful of the fact that court decisions with respect to individual contracts cannot be determined in advance of a suit. Of course based upon stipulated facts it is frequently possible for attorneys to agree as to the legal situation, and while I may be entirely wrong I am inclined to believe, assuming the facts to be stated correctly in the question referred to, that a legal opinion would require the calculation of the bonus upon the profits without considering the federal tax even though it may not be equitable.

Yours very truly,

C. F. Seeger.

The following reply was written to this letter:

Dear Sir: It seems to me that it is pertinent to inquire the purpose of the cases in which decisions were rendered disallowing taxes as an expense. Was the point at issue the determination of net profits or taxable net income? There is of course no question that taxes can not be deducted in determining income subject to federal taxes, but I do not think that a court decision ruling out an item as an expense in determining taxable net income would necessarily be considered a precedent in a case brought to decide whether that item should be considered an expense in determining net profits subject to a bonus. That is why I should like to know just what point was at issue in the cases.

The point is an important one. If I was wrong in my opinion as expressed in the July issue, I certainly want to correct it. But whether or not I was wrong depends upon the nature of the cases in which federal taxes were held to be non-deductible. If the cases referred to in your letter were tax cases where the amount of taxable net income was at issue, I do not think that the decisions have any bearing on the question. If the cases were brought to settle a point on profits, aside from taxes, then they have a bearing.

If you care to look further into this and report on the character of the cases, and if you find that there are cases in which taxes were disallowed in computing net profit as distinguished from taxable profit, I shall be glad to give some space in a future issue to your findings.

Yours truly,

The importance of noting the nature of the point at issue in decided cases may be brought out as follows: Assume that action is brought by creditors of a corporation to prove that dividends have been paid in excess of profits, and that creditors are therefore entitled to recovery. It can scarcely be believed that the defense would admit that dividends had been paid in excess of net profits remaining after the payment of federal taxes, but not in excess of profits before the payment of federal taxes, and hence that the dividends did not exceed the profits. The rule that federal taxes are not deductible in computing taxable net income has no bearing on the ascertainment of profits available for dividends. Nor does the editor of this department believe that it has any bearing on the ascertainment of profits subject to a bonus.

To the letter printed above, Mr. Seeger replied as follows:

Editor, Students' Department:

Sir: Naturally the case or cases which I recalled related to the determination of net income for income and excess-profits tax purposes with the exception of one mentioned in Montgomery's *Income Tax Procedure, 1918*, page 302, paragraph headed "Decision Under British Act." Mr.

Montgomery states, "A decision . . . illustrates the point that income taxes are not an expense." I desire to also call your attention to page 301 of the same book on which will be found the following: "If the 50% now set apart as the government's share could be treated as an expense . . . it would produce an illogical result."

I next call your attention to page 2009, 1-30-22, paragraph 2033, in Prentice-Hall *Federal Tax Service,* volume 1, 1922, "Profit Sharing Contracts.—It is not unusual for the compensation of an employee to be contingent upon the amount of profits of the business or of a given department of the business. Unfortunately a great majority of the contracts providing for contingent compensation are so worded as to raise the question as to whether the compensation is to be based on the profits before or after the deductions of the federal income and excess-profits tax. The interpretation of a given contract depends, of course, upon its wording and the surrounding circumstances."

One can hardly conceive of an employee with the ability to manage several departments and earn a considerable bonus based upon profits being foolhardy enough to take legal issue with his employers over the matter of the deductibility of the tax in the determination of the amount of the bonus. However, it seems to me in view of the citations which I have made above from Montgomery and Prentice-Hall that considering the problem exactly as worded you can hardly afford to take the positive stand that has been taken in the *Students' Department* in determining the issue.

I disagree with you as to the relevancy that the construction which the courts place upon the tax laws in determining net income in disputed tax cases may have upon a question such as the one at issue. There may be some question with regard to the construction to be placed upon the meaning of net income as compared with profit but both Holmes and Black agree with the following quotation from Black's fourth edition of *Income and Other Federal Taxes,* page 36, paragraph 30, second sentence, namely, "All the acts of congress . . . have associated together the words 'gains,' 'profits' and 'income' as descriptive of the subject taxed."

In view of the foregoing I hold to the idea that income tax is in no sense an expense of business but a share of the profits seized by or belonging to the government under due process of law; consequently under the arrangements outlined in the problem the firm agreed to pay the manager 10% of the profits in addition to his salary as compensation for his investment of service, special ability and personal goodwill, if any. This would certainly be a legal arrangement and the bonus together with the salary an allowable deduction in determining the profits in which the government and the firm were entitled to share pro rata.

There of course could be no objection to the firm and the manager making a specific contract whereby income tax was to be considered in determining the bonus, in fact the necessity of being specific is recognized by Prentice-Hall on the same or subsequent page previously referred to where there is submitted a proposed specific clause to be inserted in a contract so as to cover this point. Now, it seems logical to me to take the position that if in order to remove question it is necessary to insert a clause in the contract, in the absence of such a clause the tax can certainly not be deducted under the wording of your problem in determining the bonus.

It also seems to me that unless a specific arrangement has been made, numerous exceptions might arise and be taken to any plan of apportioning the tax to the various departments. For example, the various percentages of gross and net profit, relative expenses, etc., as between departments. Furthermore, the plan that you outline results in a double taxation under the income-tax laws for the manager, which is hardly equitable although legal, inasmuch as he stands a part of the taxes assessible against the firm and is also subject to income tax himself disregarding exemptions.

In conclusion I want to state that I believe several of the leading firms of accountants, instead of charging income taxes as accrued or paid before determining net profits, are carrying net profits to surplus account and then charging as a direct item the income taxes against surplus. I know this has been done for several years past by one of the large New York firms, several of whose partners are on the council and committees of the American Institute. This has been in relation to the accounts of a large concern in which I am interested.

Assuring you that the reason for my taking issue with you is in order to get the point satisfactorily settled because I feel, like you, that it is an important one, and thanking you for your promptness in replying to my letter, I remain,

Yours very truly,

CHARLES F. SEEGER.

The paragraph in Montgomery's *Income Tax Procedure, 1918*, page 302, is the following:

"A decision under the British income act illustrates the point that income taxes are not of the nature of expenses:

"'A gas company was prohibited by its special act from paying dividends to its shareholders above a fixed rate per annum. The company claimed to deduct the amount of the income tax from its gross profits before paying any dividend and then to pay the dividend in full to the shareholders. Held that the company was not entitled to do so, and that in arriving at the rate of dividend, the profits ought to be calculated as inclusive, and not exclusive, of the amount payable in respect of income tax.'"

To be quite honest about it, the editor of this department does not know what this decision means. But it does not seem possible that it means a requirement for the corporation to pay a dividend equal to the full amount of the profits before deducting the tax, because if the company started the year with no surplus, the payment of such a dividend would certainly leave it with a deficit at the end of the year.

In quoting from page 301 of the same book by Mr. Montgomery, a very important part of the sentence was omitted. The full quotation is: "If the 50 per cent now set apart as the government's share could be treated as an expense by the taxpayer *and operate to diminish the amount due to the government*, it would produce an illogical result." The words in italic are the words omitted by Mr. Seeger; the italic is the editor's. But the point is that this quotation has reference to the deductibility of federal taxes in determining taxable net income. And it is the contention of the editor that rulings prohibiting the deduction of federal taxes in computing taxable net income do not necessarily apply to the computation of the real net profit of a corporation.

The Prentice-Hall *Federal Tax Service* quotation merely amounts to this: It is desirable to insert a clause in the bonus contract stating definitely what will be done about federal taxes in determining profits subject to the bonus. Mr. Seeger says: "Now, it seems logical to me to take the position that if in order to remove question it is necessary to insert such a clause in the contract, in the absence of such a clause the tax can certainly not be deducted under the wording of your problem in determining the bonus." That seems to the editor a good deal like begging the question. We must get back to the crux of the problem: either the tax is an expense or a distribution of profits. Now if it is an expense it would be as logical for Mr. Seeger to say that no expense could be deducted unless the contract with the employee mentioned that expense. Hence the statement that "the tax can certainly not be deducted" merely begs the question by assuming that the tax is a distribution of profits.

The editor was not able to obtain a fourth edition of Black's *Income and Other Federal Taxes,* but in the third edition he found a section on gains, profits and income in which much the same idea was expressed as in the sentence quoted. But this section dealt with the subject only from the tax standpoint. In other words, the quotation unquestionably means that all the acts of congress (dealing with income taxes) have associated together the words "gains," "profits" and "income" as descriptive of the subject taxed.

Mr. Seeger insists that the construction which the courts place upon the tax laws in determining net income in disputed tax cases is relevant in determining net income for other purposes. If the rules for determining taxable net income are always the same as the rules for determining corporate profits for other purposes, the discussion is of course closed. But the editor does not believe that this is so. One instance has already been cited. The editor can not believe that a corporation beginning the year with no surplus, making $40,000.00 profits before taxes, paying $5,000.00 in taxes, and having $35,000.00 left, could pay dividends of $40,000.00 without impairing its capital and incurring all the risks involved in an impairment of capital by the payment of dividends. Now, if the tax law does not apply to the computation of profits for dividend purposes, what reason is there for believing that it applies to the computation of profits for any other purpose (except taxes) such, for instance, as the computation of profits subject to a bonus?

Now let us look at the question in another and practical light. It is probably safe to say that prices are determined in a broad way at least by considering the amount necessary to obtain in order to pay for materials, labor and all other charges and leave a residue for profits. It can hardly be doubted that if all business men suddenly found that their rents were being enormously increased, prices would go up. Similarly, when federal taxes increased, prices went up. But they went up so as to provide a larger margin which could absorb the taxes and leave profits adequate to pay a return on capital. Of course it is not contended that if there were no federal taxes the net profit of corporations would be exactly the same as it is now after the payment of taxes. But there is at least a conscious tendency to raise prices enough to produce a wider margin, so that the deduction and payment of taxes will leave the same net profit as before. The business management knows that this larger margin is required in order to cover the additional charge, which it considers an expense. Is it logical for the employee to contend that this tax is not an expense?

That this increased margin necessitated by the tax is all profit and insist on a bonus based thereon? Is it not more logical for the employee to recognize that profits *after* deduction of taxes are probably approximately the same as profits would be if there were no federal tax, so that in reality he does not suffer by the deduction of the tax in determining the profits subject to the bonus, but would reap an unjustifiable benefit by taking his bonus on the profits before deducting the tax?

Joint Ventures and Partnerships.

It is a well-known principle of law that in the absence of an express agreement to the contrary partners are assumed to have agreed to share profits equally, regardless of their capital investments. A problem in joint-venture profits was submitted to this department and a solution was printed in the July issue. Two letters have been received by the editor maintaining that the assumption as to an equal profit-and-loss division does not apply in joint ventures. These letters contend that in the absence of an express agreement the law assumes that profits will be shared in the capital ratio.

Since receiving these letters the editor has made inquiries among attorneys but has been unable to find one who knows of a different legal assumption as to profit-sharing by participants in a joint venture. The point seems sufficiently important to justify re-printing the problem and solution, together with one of the letters. If the legal assumption as to joint-venture profit-sharing differs from the legal assumption as to partnership profit-sharing, it is hoped that some reader will furnish the editor with citations covering the law, as well as a legal rule for determining when a business is to be considered a partnership and subject to the legal assumption of an equal division of profits, and when it is to be considered a joint venture and subject to some other legal assumption as to the division of profits.

Question.—Submitted by T. W. B.

A and B purchase an invoice of cotton consisting of 200 bales for which they pay $20,000.00. Of this amount A contributes $12,500.00 and B contributes $7,500.00. Later C offers $10,000.00 for a one-third interest in this invoice, which A and B accept. You are asked to submit figures on which to base the distribution of this $10,000.00; so that both A and B will receive absolute justice and that they may all continue equally interested in the venture.

Answers.—Submitted by T. W. B.

No. 1.

Withdrawal of original investment by A and B:

A—withdrawal $12,500.00—$6,666.67= $5,833.33
B—withdrawal 7,500.00— 6,666.67= 833.34

Premium on sale of ⅓ interest to C:

$10,000.00—$6,666.67=$3,333.33

A—50% of $3,333.33	$1,666.67
B—50% of 3,333.33	1,666.66

Total distribution of $10,000.00 paid by C:

	Capital	Premium	Total
A	$5,833.33	$1,666.67	$7,500.00
B	833.34	1,666.66	2,500.00
Total			$10,000.00

No. 2.

Withdrawal of original investment by A and B:

A—withdrawal (as above)	$5,833.33
B—withdrawal (as above)	833.34

Premium on sale of 1/3 interest to C=$3,333.33 as above.

A—5/8 of $3,333.33	$2,083.33
B—3/8 of 3,333.33	1,250.00

Total distribution of $10,000.00 paid by C:

	Capital	Premium	Total
A	$5,833.33	$2,083.33	$7,916.66
B	833.34	1,250.00	2,083.34
Total			$10,000.00

No. 3.

Withdrawal of original investment by A and B:

A—withdrawal (as above)	$5,833.33
B—withdrawal (as above)	833.34

Premium on sale of 1/3 interest to C—$3,333.33 divided 50 cents on each $1.00 withdrawn.

A—$5,833.33 x .50	$2,916.67
B— 833.33 x .50	416.66

Total distribution of $10,000.00 paid by C:

	Capital	Premium	Total
A	$5,833.33	$2,916.67	$8,750.00
B	833.34	416.66	1,250.00
Total			$10,000.00

EDITOR'S COMMENTS IN JULY ISSUE.

The above problem, submitted by T. W. B., cannot be solved with any certainty because there is no statement as to the ratio in which profits are to be shared. If profits are shared equally, the first solution is correct. If they are shared in the capital ratio, the second solution is correct. In the absence of an agreement, partnership profits are shared equally; therefore, in the absence of a stated agreement, the first solution must be assumed to be correct. I cannot see that the third solution would be correct in any circumstances.

Editor, Students' Department:

SIR: The problem submitted by T. W. B. is a modification of a famous C. A. problem abroad. The terms of the problem, as submitted, provide that a one-third interest in the venture as started by A and B is sold to C for $10,000.00, thus leaving A, B and C at one-third interests respectively.

Now the absence of an agreement as to the sharing of partnership profits and losses would be of no effect in this case, since the thing parted with A and B was an interest in their venture—which was to buy and sell, if possible, a certain parcel of cotton. That is, in contemplation of the law, the premium or bonus paid by C to secure a one-third interest in the venture is not a profit from the venture. The results of the venture remain problematical until the cotton is finally disposed of. Therefore, "so that both A and B will receive absolute justice and that they may all continue equally interested in the venture," the payment of C should be apportioned between A and B on the basis of their original contributions but giving consideration to the one-third interest retained by each of them respectively. For example:

	Original capital contributions			Capital interest retained		Share of capital interest contributed by A & B to C	
A..	$12,500.00	(5/8)	Deduct	$6,666.67	(1/3)	$5,833.33	(7/24)
B..	7,500.00	(3/8)	Deduct	6,666.66	(1/3)	833.34	(1/24)
	$20,000.00	(8/8)		$13,333.33	(2/3)	$6,666.67	(1/3)

Hence, since the one-third interest purchased by C is contributed 7/24 (or seven parts) by A, and 1/24 (or one part) by B, the $10,000.00 should be apportioned on the same basis, i. e.:

A	7/8	$8,750.00
B	1/8	1,250.00
Total		$10,000.00

The method of adjusting the capital accounts on the books is obvious.

This agrees with the results of solution 3, which you totally reject, although the detail there is not stated properly.

Yours truly,

James Symington.

New York.

To this letter the editor of the *Students' Department* replied:

Dear Sir: I have your very good-natured criticism of my solution to the joint-venture problem. Incidentally, I received in the same mail another letter taking exactly the same stand which you take.

Still, I cannot agree with you, although I am willing to be convinced. To be convinced, however, I shall have to be shown that the law in regard to distribution of joint-venture profits is different from the law in regard to the distribution of partnership profits. May I ask you two questions?

First, does joint-venture law assume a division of profits in the capital ratio, or in the ratio of capital interests sold, instead of equally as in the case of partnership law?

Second, let us assume that the word partnership had been used instead of joint venture. A and B are in partnership, dealing in cotton. They invested $12,500.00 and $7,500.00 respectively, and put it all into cotton. Nothing is said in regard to the sharing of profits. Then the law provides that the profits shall be shared equally. Now, in admitting C by a transfer of $5,833.33 from A's capital and a transfer of $833.34 from B's capital, a profit of $3,333.33 is made. Where is my logic wrong when I take the position that this $3,333.33 is a profit which the partners take now instead of waiting to take in the future? If A and B had not admitted C, but had waited to take their profits by a sale of the cotton, they would have shared the profit in equal parts, in the absence of an agreement. But they do admit C and he will get some of the ultimate profit which A and B would otherwise have divided equally. Why should they not divide this ***nunc pro tunc*** profit equally?

If I have made a mistake in this solution I do not want to let it go uncorrected, and I shall appreciate any citations which will demonstrate an error if one exists.

Yours truly,

There are really two points at issue here.

First: Does the law assume that joint-venture profits from operations shall be shared in the capital ratio instead of equally? If so, this is entirely different from the assumption governing partnerships, and it becomes necessary to have well-defined rules by which joint ventures and partnerships can be distinguished.

Second, does one rule govern the distribution of operating profits while another rule governs the distribution of profits arising from the sale of a capital interest?

This second question is important because it will be noted that in the third solution, which Mr. Symington contends is the correct one, the profit on the sale of the capital interest is not divided equally nor in the ratio of the capital investments, but in the ratio of the capital interests sold.

It should be remembered that the correct solution of this problem depends upon law, not upon ideas of fairness. It may be fairer to divide profits in the capital ratio than to divide them equally; the law will protect such an agreement but will not assume that such an agreement was made. And it may be fairer to divide profits from the sale of a capital interest in the ratio of the interests sold than to divide them equally; but if the law makes a distinction between operating profits and realization profits from the sale of a business or a portion thereof, applying one rule to the division of operating profits and another rule to the division of profits from the sale of a capital interest, the editor of this department is not aware of it.

In conclusion, the first solution seems to be correct if the legal assumption of an equal division of profits applies with equal force to joint-venture and partnership profits, and if the division of profits from the sale of a capital interest is governed by the same legal rules as profits from operations.

The second solution is correct if the law requires the division of joint-venture profits (in the absence of an agreement) in the capital ratio, while requiring the division of partnership profits equally.

The third solution is correct if the law makes a distinction between operating profits and profits from the sale of a capital interest, requiring that the profits from the latter source shall be divided in the ratio of the capital interests sold.

Division of Partnership Goodwill.

The May examination of the American Institute of Accountants contained a problem requiring the computation of the goodwill of a partnership, and the computation of the interest of a retiring partner in this goodwill. The goodwill was to be computed on the basis of the profits of the three years next preceding the partner's retirement.

During those years the profit-and-loss ratio changed, the profits being divided among the partners in a different ratio each year. In the published solution in the July issue, the editor allowed the retiring partner a portion of the goodwill computed by multiplying the total goodwill by the retiring partner's profit-sharing rate for the third year, which was also, of course, the year of his retirement.

Editor, Students' Department:

SIR: Your solution of problem 1, of the American Institute of Accountants' examination in accounting theory and practice, given May 18, 1922, has been carefully studied, and it appears to the writer that the division of the goodwill on the basis of the profit-and-loss ratio for the year in which it is placed upon the books is in error for the following reasons:

First, such division would naturally infer that the goodwill was earned in that year. The mere fact that the goodwill earned by the partnership was not placed on the books until the end of the third year would in no way set aside the fact that it was earned in the previous years, as well as the current year. While it might be contended that it was earned in the third year by reason of its realization, yet the fact remains that the goodwill was actually earned during the life of the partnership.

Second, accepting the reasoning as above, it would be apparent that an injustice would be wrought on the partners by dividing it on the basis of the profit-and-loss ratio of the third year.

The writer has failed to find this condition covered in the accounting works he has available and would appreciate an authority for dividing such goodwill.

In the writer's solution it was assumed that the goodwill was earned in the same proportion that the income was earned, and the amount was then divided by taking the profit-and-loss ratio for each year. The examiners passed the writer in this examination, and he is interested in knowing the correct solution.

Thanking you for any information you may be able to furnish, I am

Yours truly,

Pittsburgh, Pa. R. J. LAVALLEE.

The payment for goodwill is not a payment for past profits; if it were, it would probably be correct to divide the goodwill among the partners in the average profit-and-loss ratio of the past. But the payment for goodwill is a payment for future profits. The retiring partner will not share in these future profits because he will no longer be a partner, but in retiring he is entitled to compensation for his share of the net assets and also for his share in the future profits which will be in excess of a fair return on the capital. He is entitled to compensation for these future excess profits because, presumably, he helped to develop the business to the point where it pays excess profits.

Recourse is had to past profits in computing the goodwill only because these past profits are considered the best available evidence of the probable future profits. But it is future profits which are being paid for when payment is made for goodwill. The retiring partner's share of these future profits will, presumably, be his present profit-and-loss per cent because the profit-and loss ratio can not be changed in the future without his consent. That is, if he remained in the partnership, he would share in the future profits in the same ratio that he shared profits during the year preceding his retirement, unless of course he consented to some other ratio. Hence, the distribution of goodwill on the basis of the last year's profit-and-loss ratio is merely an immediate allowance to the retiring partner for future profits, in the ratio in which he would have shared these future profits. A distribution of the goodwill in the average profit-and-loss ratio of the past would not be correct unless there was an intention to share profits in the future in the average ratio of the past instead of in the ratio existing at the time of the dissolution.

Problem in Manufacturing Overhead.

A reader has requested a solution to the following problem:

The Universal Manufacturing Company commenced business January 1, 1921, with a paid-up capital of $700,000.00. The following is a trial balance of the company at December 31, 1921:

	Debits	Credits
Cash	$40,000	
Accounts receivable	51,000	
Accounts payable		$83,000
Notes payable		150,00
Branch current account	143,000	
Plant and equipment	400,000	
Raw materials purchased	600,000	
Productive labor	200,000	
Non-productive labor	50,000	
Manufacturing supplies and expenses	100,000	
Selling expenses	80,000	
Administrative expenses	80,000	
Interest paid	8,000	
Cash discount earned		6,000
Cash discount allowed	12,000	
Sales to customers and branches, 80,000 units at $10.00 each		800,000
Capital stock		700,000
Reserve for depreciation		25,000
	$1,764,000	$1,764,000

The inventories at December 31, 1921, as shown by the books, follow:

Raw materials	$150,000
Work in process	100,000
Finished goods	150,000

The corporation declared a dividend December 27th of 5% on the capital stock, payable January 2, 1922.

A profit-and-loss statement was submitted to the bank showing net profit of $76,000.00.

Upon examination the following is found:

The cost records are not controlled by the general books.

The raw materials on hand were valued at cost, the market value of which was $100,000.00.

The burden taken into cost of production for the year consisted of $50,000 for indirect labor, $100,000 for manufacturing supplies and expenses and $50,000 for interest on investment.

The work in process was valued as per the cost sheets of the company as follows:

Material	$21,000
Productive labor	39,500
Burden	39,500
	$100,000

You are informed by the management that the factory operated 50% of the normal capacity during the year; also that the manufacturing burden as previously stated was the normal burden based on 100% capacity.

The finished units on hand at December 31, 1921, amounted to 20,000 valued at $150,000 as per cost sheets.

The branch office reports the following:

Cash	$3,000	
Accounts receivable	40,000	
Purchases from home office: 60,000 units at $10	600,000	
Sales: 50,000 units		$500,000
Home office account		143,000

The units at the branch office at December 31, 1921, amounted to 10,000.

Required: balance-sheet at December 31, 1921; statement showing cost of production and profit and loss.

UNIVERSAL MANUFACTURING COMPANY

Statement of Cost of Goods Manufactured

Year Ended December 31, 1921

Raw materials:			
Purchases		$600,000.00	
Less inventory—December 31, 1921—cost		150,000.00	
Cost of raw materials used		450,000.00	
Add market decline in inventory—Dec. 31, 1921:			
Cost	150,000		
Market	100,000		
		50,000.00	
Charge to manufacturing for raw materials			$500,000.00
Productive Labor			200,000.00
Manufacturing expense:			
Non-productive labor		50,000.00	
Manufacturing supplies and expense		100,000.00	
Total manufacturing expense—75% of labor			150,000.00
Total			850,000.00
Deduct goods in process—December 31, 1921:			
Materials (cost $21,000) market value		14,000.00	
Productive labor		39,500.00	
Burden: 75% of $39,500		29,625.00	
			83,125.00
Cost of manufacture of 100,000 units			766,875.00

The $50,000.00 loss due to the decline in the market value of the raw materials, is thrown into the manufacturing cost because this would be the customary effect of valuing the closing inventory at market instead of cost. It would be more logical, however, to include in manufacturing cost only the cost of the materials used and to make the $50,000.00 decrease in the value of the closing inventory a direct profit-and-loss charge.

UNIVERSAL MANUFACTURING COMPANY

Profit-and-Loss Statement

Year Ended December 31, 1921.

Sales:		
At home office—20,000 units at $10.00		$200,000.00
At branch office—50,000 units at $10.00		500,000.00
Total		700,000.00
Deduct cost of sales:		
Cost of 100,000 units manufactured	$766,875.00	
Cost of 30,000 units unsold	230,062.50	
		536,812.50
Gross profit on sales		163,187.50
Deduct selling expenses		80,000.00
Net profit on sales		83,187.50
Deduct administrative expenses		80,000.00
Net profit on operations		3,187.50
Deduct net financial expense:		
Interest paid	8,000.00	
Cash discount allowed	12,000.00	
Total	20,000.00	
Less cash discount earned	6,000.00	
		14,000.00
Net loss for the year		$10,812.50

UNIVERSAL MANUFACTURING COMPANY

Balance-sheet, December 31, 1921

ASSETS

Fixed assets:		
Plant and equipment	$400,000.00	
Less reserve for depreciation	25,000.00	
		$375,000.00
Current assets:		
Inventories:		
Raw material	100,000.00	
Goods in process	83,125.00	
Finished goods	230,062.50	
		413,187.50
Accounts receivable		91,000.00
Cash		43,000.00
		$922,187.50

LIABILITIES

Current liabilities:		
Accounts payable	$83,000.00	
Notes payable	150,000.00	
Dividends payable	35,000.00	
		$268,000.00
Capital:		
Capital stock	700,000.00	
Less deficit	45,812.50	
		654,187.50
		$922,187.50

LAWRENCE E. BROWN

Lawrence E. Brown, member of the American Institute of Accountants, died at Philadelphia, October 30, 1922. Mr. Brown was a member of the firm of Lawrence E. Brown & Company. He was a member of the Pennsylvania Institute of Certified Public Accountants and had been in practice in Philadelphia for many years.

W. W. STERRETT

W. W. Sterrett, member of the American Institute of Accountants, died at Devon, Pennsylvania, October 28, 1922. Mr. Sterrett was a certified public accountant of Pennsylvania and a member of the Pennsylvania Institute.

THOMAS E. TURNER

Thomas E. Turner, member of the American Institute of Accountants, died November 15, 1922, at Louisville, Kentucky. Mr. Turner was a member of the firm of Turner, Spencer & Co., and was one of the pioneers of accountancy in Kentucky.

GEORGIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

At a meeting of the Georgia Society of Certified Public Accountants, held October 28, 1922, the following officers were elected: President, Joel Hunter; first vice-president, Alonzo Richardson; second vice-president, C. H. Highley; third vice-president, Thos. J. O'Brien; secretary, W. H. James; treasurer, G. N. Spring.

OHIO SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

At the annual meeting of the Ohio Society of Certified Public Accountants the following officers were elected:—L. G. Battelle, president; C. A. Gano, vice-president; W. E. Langdon, secretary and treasurer; and E. A. Roden, W. D. Wall, R. A. Hurst and W. F. Vieh, directors.

Gladstone Cherry and George H. Cheyne announce the formation of a partnership under the firm name of Gladstone Cherry, Cheyne & Company with offices at 818-820 First Wisconsin National Bank building, Milwaukee, Wisconsin.

Emlyn E. Jones and Arnett Potter announce the formation of a partnership under the firm name of Jones & Potter, with offices at 614 Weightman building, Philadelphia.