[Journal of Accountancy](https://egrove.olemiss.edu/jofa)

Volume 31 | Issue 2 Article 8

2-1921

Students' Department

H. A. Finney

Students' Department

EDITED BY H. A. FINNEY

The examination questions of the American Institute of Accountants are now used by thirty-two state C. P. A. boards as well as by the institute. Readers of THE JOURNAL OF ACCOUNTANCY who were candidates in the November examinations conducted by these boards or by the institute are, therefore, already familiar with the problems. These solutions, it should be understood, merely represent the opinion of the editor of this department and are not official solutions by the institute.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE
PART I—*Continued*

Question 4:

Mr. Richard Roe, a married man, requests you to prepare his federal income-tax return for the ten months ended December 31, 1919, from the following information which he has submitted to you:

Salary	$ 5,000.00
Directors' fees	105.00
Rent of property (net)	7,596.54
Interest on investments	1,648.32
Dividends on bank stock	2,500.00
Dividends on stock held in industrial companies	11,500.00
Dividends on stock of a corporation organized and doing business in a province of Canada	1,500.00

He has paid out:

Interest on his personal indebtedness	2,500.00
Taxes on income-producing real property	1,600.00
Taxes on real property not producing income	400.00
Personal household expenses	2,500.00

He also reports:

Loss of a dwelling house, from which he had received rents, by fire, no insurance being carried	1,200.00
Judgment rendered against him in his suit to collect the past due note of Harry Hanson—	
Principal	2,000.00
Interest	320.00
Legal expenses	150.00
	$2,470.00

State the resultant tax. The rates for individual taxes for 1919 were:

First $4,000.00—4%, thereafter 8%

Surtax

$ 5,000.00	to	$ 6,000.00—	1%
6,000.00	"	8,000.00—	2%
8,000.00	"	10,000.00—	3%
10,000.00	"	12,000.00—	4%

$12,000.00	to	$14,000.00—	5%
14,000.00	"	16,000.00—	6%
16,000.00	"	18,000.00—	7%
18,000.00	"	20,000.00—	8%
20,000.00	"	22,000.00—	9%
22,000.00	"	24,000.00—	10%
24,000.00	"	26,000.00—	11%
26,000.00	"	28,000.00—	12%
28,000.00	"	30,000.00—	13%

A married man is entitled to an exemption of $2,000.00.

Solution, Question 4 (by Eric L. Kohler):

	Subject to	
	Normal tax	*Surtax only*
Taxable income:		
Salary	$ 5,000.00	
Directors' fees	105.00	
Rent of property (net)	7,596.54	
Interest on investments	1,648.32	
Dividends on Canadian stock	1,500.00	
Dividends on bank stock		$ 2,500.00
Tax paid by bank on stock		
Dividends on industrials		11,500.00
Total gross income	$15,849.86	$14,000.00
Allowable deductions:		
Interest	$ 2,500.00	
Taxes (including bank stock tax)	2,000.00	
(1) Loss by fire (less depreciation already recovered)	1,200.00	
(2) Bad debt	2,150.00	
Total deductions	$ 7,850.00	
Net income subject to normal tax	$ 7,999.86	
Add dividends	14,000.00	
Total net income subject to surtax	$21,999.86	
Computation of tax:		
Normal tax—		
Net income subject to normal tax	$ 7,999.86	
Less normal tax credit:		
(3) Personal exemption—10 months.	1,666.67	
	$ 6,333.19	
4% on first $4,000.00	$ 160.00	
8% on balance of $2,333.19	186.66	$ 346.66
Surtax—		
(4) 9 x 8 x 10 — 10	$ 710.00	
9% of $1,999.86	179.99	889.99
Total tax payable		$1,236.65

Notes:

(1) Loss of an individual's own residence through fire may be deducted to the full extent of its cost or fair market value at March 1, 1913, if purchased prior to that date, without allowance for accrued depreciation. In this case, the house having been rented, depreciation thereon has been an allowable deduction during each taxable year.

(2) If accrued interest of $320.00 has been reported as income in this return or in a prior return, the amount thereof uncollected may also be deducted.

(3) The return being on the basis of 10 months, only 5/6 of the personal exemption may be deducted. A return for less than a year may be made only in case the taxpayer is changing, with the consent of the commissioner, from a fiscal to calendar year.

(4) The rule for calculating surtaxes on income not exceeding $100,000.00, follows:

Ascertain the highest even number of thousands contained in the net income (in the above, 20), divide by 2, and (a) subtract 1 and (b) subtract 2; multiply a x b x 10, and subtract 10 (9 x 8 x 10 — 10), the result being the surtax on the highest even thousand. The balance of the income (which will be less than $2,000.00) is subject to a surtax equal to a (the a above) percent thereof.

Question 5:

The balance-sheet of the Rozinante Company at June 30, 1920, was as follows:

Assets		*Liabilities*	
Plant and equipment	$15,000.00	Capital stock	$25,000.00
Merchandise	3,000.00	Accounts payable	2,000.00
Cash	1,000.00		
Deficit	8,000.00		
	$27,000.00		$27,000.00

A and B buy the entire stock, new certificates being made out to them in equal proportions. The price agreed upon is $20,000.00, of which $15,000.00 is paid in cash, the balance being represented by a joint and several note for $5,000.00 signed by A and B. In addition, the former stockholders, X and Y, as part of a contract, are allowed to withdraw the $1,000.00 cash shown in the above balance-sheet.

Without consulting an accountant, A and B open a new set of books, but are uncertain how much to credit capital stock. They therefore ask the former stockholders what their $25,000.00 credit to capital stock represents, and are informed that "it was the amount we paid for the stock of the corporation when it was organized." Acting on this information they credit capital stock with the price they agreed to pay for it, opening new books by the following journal entry:

Plant and equipment	$15,000.00	
Merchandise	3,000.00	
Goodwill	9,000.00	
Capital stock		$20,000.00
Accounts payable		2,000.00
Notes payable to X and Y		5,000.00

As the corporation is in need of funds an attempt is made to borrow $1,500.00. The bank will not accept the corporation's note, but offers to lend $750.00 to A and the same amount to B on their personal notes. The notes are issued and the cash is deposited in bank to the credit of the corporation. A and B agree that this $1,500.00 shall be considered "an additional investment," and an entry is made debiting cash and crediting capital stock, $1,500.00.

When the notes mature a cheque for $1,500.00 is drawn on the corporation's bank account, but the bookkeeper does not know what account to charge and asks for your advice. Upon investigation you find the facts as set forth above.

Comment on the propriety of the transactions and the entries and state what entries you would advise the bookkeeper to make.

Solution, Question 5:

This problem illustrates the confusion which exists in the minds of a good many people who fail to recognize the distinction between a corporation and a partnership. The sale of all the stock to A and B should have had no effect on the corporation's books except to the extent of the $1,000.00 of cash withdrawn by the former stockholders and the change of stockholders shown in the stock ledger. The withdrawal of the cash increased the deficit to $9,000.00, and an entry should have been made debiting deficit and crediting cash $1,000.00. It is probable that A and B could be held liable to creditors for the amount of this $1,000.00 if the corporation became incapable of paying its debts. Their consent to the withdrawal in conjunction with the purchase of the stock would probably be interpreted by a court as equivalent to a withdrawal of $1,000.00 by them at a time when there was no surplus.

The payment of $15,000.00 in cash and the issuing of notes for $5,000.00 is a private matter between A and B on the one hand and X and Y on the other, and no entry for the transaction should have been made on the corporation's general books.

The $9,000.00 charge to goodwill is also wrong. A corporation does not acquire goodwill when a portion or all of its stock changes hands, even though the price paid is greater than the book value of the stock. The $9,000.00 should appear in deficit account.

It was not necessary to open new books, but there is nothing improper in doing so, provided the entries are correct. The entries as made were wrong and should be reversed.

Capital stock	$20,000.00	
Accounts payable	2,000.00	
Notes payable to X and Y..................	5,000.00	
Plant and equipment		$15,000.00
Merchandise		3,000.00
Goodwill		9,000.00

To reverse entry opening new books.

An entry should then be made reopening the books correctly. After making an entry on the old books charging deficit and crediting cash $1,000.00, the proper entry on the new books would be:

Plant and equipment	$15,000.00	
Merchandise	3,000.00	
Deficit	9,000.00	
Capital stock		$25,000.00
Accounts payable		2,000.00

To transfer balances from old to new ledger.

These entries have the following results:

The goodwill is eliminated and the deficit shown;

The capital stock account shows the par of the stock outstanding;

The notes payable account is eliminated, since the notes are personal and not corporate.

The entry for the issue of the two notes totaling $1,500.00 should be reversed:

Capital stock	$1,500.00	
Cash		$1,500.00

To reverse entry crediting capital stock with proceeds of two notes of $750,000 each, issued by A and B.

No entry should be made for the notes themselves, as they are not a liability of the corporation, but since the cash proceeds are to be treated as additional investments reducing the deficit, the following entry should be made:

Cash	$1,500.00	
Deficit		$1,500.00

Cash donation by A and B; $750.00 each.

When the notes mature, they should be paid by A and B individually. If they are paid from the corporation's cash, the cash payment should be regarded as a loan to A and B, and should be recorded as follows:

A loan	$750.00	
B loan	750.00	
Cash		$1,500.00

Cash lent to A and B with which to pay their notes.

Question 6:

The following letter is received by a practising accountant from a man not previously known to the former:

"I am contemplating the purchase of a business, the proposal of the present owner being that I pay him a flat price of $500,000.00 He states that the plant and real estate are worth $200,00.00, the inventories and accounts receivable $250,000.00 and the cash $30,000.00. The liabilities of the business which would be assumed by the purchaser amount to $120,000.00. The profits are said to be good and stable.

"The nature of the business appeals to me and I am much interested in the proposition, but I have never had any experience in such matters and cannot make up my mind. I do not know how to determine what the business is worth or what dangers are involved in taking over a business in this way. My lawyer has suggested to me that public accountants are generally employed in such circumstances. Not having engaged any in the past I do not know in just what way their services would be useful to me in making up my mind or in taking delivery if I should accept the proposition.

"Will you kindly advise me in the matter?"

Write an answer to the above letter.

Answer, Question 6:

DEAR SIR:

The advisability of purchasing a business depends upon two factors: the value of the net assets and the amount and stability of the profits. A public accountant may be of service to a prospective purchaser by making an examination of the books of the business and rendering an unprejudiced report covering the net assets and the profits.

As to the net assets of the business which you contemplate purchasing, the plant and real estate should be appraised unless you are expert enough in the valuation of such property to be willing to reply on your own judgment. An accountant can report on the value of the other assets after making an audit. If you are to assume the liabilities of the business as part of the contract of purchase, you will want to be as certain as possible that all the liabilities are on the books and included in the $120,000.00. The search for unrecorded liabilities is part of the service which an accountant can render in such cases.

If an audit shows the assets and liabilities to be as stated, and if you are to get the $30,000.00 cash, the conditions are as follows:

Purchase price		$500,000.00
Deduct net assets:		
Plant and real estate	$200,000.00	
Inventories and accounts receivable	250,000.00	
Cash	30,000.00	
Total assets	$480,000.00	
Liabilities	120,000.00	360,000.00
Excess of purchase price over net assets		$140,000.00

The payment of this excess would be inadvisable unless the profits are sufficiently good to insure you a return on this extra investment. In other words, you are being asked to pay $140,000.00 for the goodwill of the business, and you ought to be quite certain that the business has a goodwill. This is where an accountant can probably be of the greatest service to you by checking up the books of the business for several years to see whether the profits have been properly computed, whether they have been large enough to pay a return on the excess payment of $140,000.00, and whether they have been stable enough to make it probable that your investment of $500,000.00 will pay a good income regularly.

If you care to have me go into this matter for you, we can arrange a conference to discuss the details.

Yours truly,

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE PART II

November 17, 1920, 1 P. M. to 6 P. M.

Answer questions 1, 2 and 3 and any three other questions.

Question 1:

You are requested by the president of a corporation to assist in the preparation of the federal income and excess-profits tax return of his company for the calendar year 1919, and for the purpose thereof the following data are submitted to you:

THE NOVEMBER CORPORATION

CONDENSED TRIAL BALANCE (AFTER CLOSING)

For the year from January 1, 1919, to December 31, 1919

	January 1		December 31	
Particulars	Dr.	Cr.	Dr.	Cr.
Properties	$ 2,500,000.00		$ 3,500,000.00	
Deprec'on reserve.		$ 500,000.00		$ 700,000.00
Goodwill acquired for stock.......	1,500,000.00		1,500,000.00	
Invest'nts in stock of other corps. at cost—				
Domestic corps. (25% interest).	250,000.00		250,000.00	
Foreign corps. (20% interest).	100,000.00		100,000.00	
Inventories	3,000,000.00		5,000,000.00	
Inventory reserves		500,000.00		1,000,000.00
Receivables	2,500,000.00		3,000,000.00	
Bad debt reserves.		100,000.00		250,000.00
Cash	1,400,000.00		2,000,000.00	
Bond discount....	90,000.00		80,000.00	
Commission paid on issue of common stock......	60,000.00		60,000.00	
Prepaid expenses.	50,000.00		40,000.00	
Preferred stock..		1,500,000.00		1,125,000.00
Common stock....		2,500,000.00		4,500,000.00
Bonds		1,000,000.00		1,000,000.00
Current liabilities.		1,600,000.00		1,105,000.00
Provision for federal income and profits taxes....		700,000.00		2,000,000.00
Contingent reserve		250,000.00		250,000.00
Preferred stock redempt'n fund.		150,000.00		525,000.00
Earned surplus...		2,150,000.00		2,575,000.00
Capital surplus resulting from appraisal of properties		500,000.00		500,000.00
	$11,450,000.00	$11,450,000.00	$15,530,000.00	$15,530,000.00

STATEMENT OF PROFITS AND INCOME

For the year ended December 31, 1919

Sales		$25,000,000.00
Less cost of sales		15,000,000.00
Gross profit		$10,000,000.00
Deduct selling, general and administration expenses:		
Selling expenses		$ 3,500,000.00
Advertising		500,000.00
Collection expenses		200,000.00
Contingent losses on bad and doubtful accounts		200,000.00
General office salaries		100,000.00
Profit-sharing bonus of executives		250,000.00
Taxes:		
Real and personal property tares		50,000.00
Capital-stock tax		5,000.00
Special assessments		10,000.00
Life insurance policy premiums		5,000.00
Charitable contributions:		
Public subscriptions		25,000.00
Employees' welfare		30,000.00
Total expenses		$4,875,000.00
Net profits from operations		$5,125,000.00
Add other income:		
Dividends received from domestic corporations	$ 100,000.00	
Dividends on foreign investments	50,000.00	
Interest received	10,000.00	160,000.00
		$5,285,000.00
Deduct:		
Interest paid	$ 250,000.00	
Proportion of bond discounts written off	10,000.00	260,000.00
Net profits and income		$5,025,000.00
Deduct:		
Expenses in connection with issue of capital stock	$ 50,000.00	
Provision for federal income taxes (preliminary estimate)	2,000,000.00	
Special reserve against inventory	500,000.00	2,550,000.00
Surplus net profits		$2,475,000.00

SURPLUS ACCOUNT

For the year ended December 31, 1919

Balance at beginning of year	$2,650,000.00
Net profits for year	2,475,000.00
	$5,125,000.00

Less:			
Excess of 1918 federal taxes actually paid over amount provided at Dec. 31, 1918..		$ 100,000.00	
Cash dividend paid on preferred stock:			
January 31, 1919..........	$ 20,000.00		
April 30, 1919............	20,000.00		
July 31, 1919..............	20,000.00		
October 31, 1919..........	15,000.00	75,000.00	
Dividends paid on common stock:			
In cash:			
February 28, 1919.......	$250,000.00		
August 31, 1919.........	250,000.00	500,000.00	
In stock:			
August 31, 1919.........		1,000,000.00	
Preferred stock redemption fund		375,000.00	2,050,000.00
			$3,075,000.00

You are also informed that the company was organized on January 1, 1910, with an authorized and issued capital of $4,150,000.00, divided as to

Preferred stock	$1,650,000.00
Common stock	2,500,000.00

You are further informed that of this capital $1,000,000.00 common stock was sold to an underwriting syndicate for cash at par, less 6% commission, and that the remainder of the stock was issued to the vendor company in acquisition of the business property, goodwill and other assets taken over. The capital stock outstanding has been unchanged from the date of organization to January 1, 1919, except as to the redemption of the preferred stock indicated, which took place March 31, 1917. The book values of the fixed properties are based on an appraisal made by an appraisal company as at March 1, 1913. In addition to the common stock dividend paid during the year, the company issued a further $1,000,000.00 common stock, which was sold for cash at par as follows:

August 31....................................	$500,000.00
October 31....................................	500,000.00

On October 31, 1919, it also redeemed for cash and retired preferred stock at par to the amount of $375,000.00.

You may assume the company was not engaged on any government contracts throughout the year 1919.

Prepare draft statements showing

(1) The amount of the company's "invested capital" for the year, which the treasury authorities will recognize for the purpose of computation of the taxes.

(2) The taxable net income for the year.

(3) The amount of income and excess-profits taxes assessable for the year. Excess-profits exemptions for 1919 were 8% of invested capital plus $3,000.00. Excess-profits rates for 1919 were:

First bracket	20%
Second bracket	40%

Income following in first bracket is that portion thereof not exceeding 20% of invested capital. Income-tax rate for 1919 was 10%, with exemptions of $2,000.00.

Solution, Question 1 (by Eric L. Kohler)

(a) ***Net taxable income:***

THE NOVEMBER CORPORATION

WORKING TRIAL BALANCE—PROFIT AND LOSS ACCOUNT

Showing reconciliation between net profits per books and taxable net income year ended December 31, 1919

	Trial balance December 31, 1919		*Non-taxable income and non-allowable deductions*		*Taxable income and allowable deductions*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Sales		$25,000,000.00				$25,000,000.00
Cost of sales	$15,000,000.00				$15,000,000.00	
Selling expenses	3,500,000.00				3,500,000.00	
Advertising	500,000.00				500,000.00	
Collection expenses	200,000.00				200,000.00	
Conting't loss—accts receivable	200,000.00		$ 150,000.00		50,000.00	
General office salaries	100,000.00				100,000.00	
Profit-sharing bonus of ex'tives	250,000.00				250,000.00	
Real & personal property taxes	50,000.00				50,000.00	
Capital-stock tax	5,000.00				5,000.00	
Special assessments	10,000.00		10,000.00			
Life insurance policy premiums	5,000.00		5,000.00			
Contributions—public subs'tion	25,000.00		25,000.00			
Employees' welfare contrib'ions	30,000.00				30,000.00	
Div.—domestic corporations		100,000.00		$ 100,000.00	100,000.00	100,000.00
Div.—foreign corporations		50,000.00				50,000.00
Interest received		10,000.00				10,000.00
Interest paid	250,000.00				250,000.00	
Bond discount written off	10,000.00				10,000.00	
Exp'ses in floating capital stock	50,000.00		50,000.00			
Provision for federal taxes	2,000,000.00		2,000,000.00			
Inventory reserve	500,000.00		500,000.00			
Net profits per books	2,475,000.00					
Non-allow'le deductions (net)				2,640,000.00		
Net taxable income					5,115,000.00	
	$25,160,000.00	$25,160,000.00	$2,740,000.00	$2,740,000.00	$25,160,000.00	$25,160,000.00

COMMENTS

(1) No details are given on provisions for depreciation, capital and revenue expenditures, etc.

(2) Collection expenses are assumed to have been actually expended and not included in part in the bad-debt reserve.

(3) By adding the year's provision for bad debts to the reserve at the beginning of the period and deducting the balance at the end the excess of bad debts collected over bad debts charged off is ascertained.

(4) The capital-stock tax is deductible (see art. 132).

(5) Special assessments for local benefits are not deductible unless for repairs.

(6) Premiums on life insurance policies are deductible only when the taxpayer is not a beneficiary thereunder. The principal, when paid, constitutes tax-free income to the individual, but taxable income to the corporation, in spite of the non-deductibility of premiums (art. 294, revised).

(7) Contributions to charitable and other corporations not subject to income tax are not deductible. However, donations to a pension fund controlled by employees or expended for the benefit of employees during the year is regarded as additional compensation to such employees and is deductible.

(8) Dividends from domestic corporations and from foreign corporations subject to United States income taxes are included in gross income and also in allowable deductions, and are therefore not subject to tax. Dividends from other foreign corporations are taxable. It is assumed that the foreign dividends here fall into the latter class.

(9) Bond discount written off is deductible if computed in accordance with standard accounting practice.

(10) Expenses connected with the issuance of capital stock are regarded as capital expenditures and therefore not deductible, no matter what procedure is followed on the corporation's books.

(11) Federal income and excess-profits taxes or provisions therefor are regarded as distributions of profits rather than expenses.

(12) The addition to the inventory reserve is deductible if it represents the difference between cost and market. On the balance-sheet, however, the $500,000.00 provision for 1920 has been added to a similar provision existing at the end of 1919, and has all the appearance of a contingent reserve rather than a valuation account.

(b) *Invested capital:*

Capital stock, surplus and reserves:

Capital stock:		
Preferred	$1,500,000.00	
Common	2,500,000.00	$4,000,000.00
Earned surplus		2,150,000.00
Appropriated surplus and non-deductible reserves:		
Contingent reserve	$ 250,000.00	
Inventory reserve	500,000.00	
Bad-debt reserves	100,000.00	
Provision for federal taxes	700,000.00	
Preferred stock redemption fund	150,000.00	1,700,000.00
Total		$7,850,000.00

Less deduction on account of goodwill:		
Goodwill acquired in 1910 for stock.....	$1,500,000.00	
Less limitation to 25% of par value of stock outstanding March 3, 1917 (i. e., 25%, $4,150,000.00).................	1,037,500.00	462,500.00
Balance		$7,387,500.00
Changes in invested capital during year:		
Additions—Common stock sold:		
Aug. 31: 123/365 of $500,000.........	$ 168,493.15	
Oct. 31: 62/365 of $500,000..........	84,931.51	253,424.66
		$7,640,924.66
Deductions:		
Federal taxes 42.260274% of $800,000.	$ 338,082.19	
Dividends:		
Jan. 31: 335/365 of $20,000.00........	18,356.16	
Feb. 28: 307/365 of $250,000.00......	210,273.97	
The remaining dividends paid during 1920, as well as the retirement of preferred stock, are amply covered by profits earned during year......		566,712.32
		$7,074,212.34
Deduction on account of inadmissible asset:		
Percentage as shown below (2,096%)...		148,275.49
Balance—invested capital for tax purposes		$6,925,936.85

Federal taxes are regarded as being paid from the surplus of the prior year; the fraction for 1920 is 42.144809%. The difference between this rate and the 42.260274% under "deductions" above is caused by the fact that 1920 had 366 days. This computation is, of course, based on the exact number of days.

COMPUTATION OF INADMISSIBLE PERCENTAGE

Average inadmissibles held......................		$250,000.00
Average all assets held	1920	
Particulars	*January 1*	*December 31*
Total per balance-sheet..................	$11,450,000.00	$15,530,000.00
Less—Depreciation reserve................	$ 500,000.00	$ 700,000.00
Reduction of goodwill................	462,500.00	462,500.00
Capital surplus (revaluation)..........	500,000.00	500,000.00
	$ 1,462,500.00	$ 1,662,500.00
Balance—admissible and inadmissible assets.	$ 9,987,500.00	$13,867,500.00
Average for year (½ sum)...............		$11,927,500.00
Ratio of average inadmissibles to average all assets		2.096%

COMMENTS

(1) It may be noted here that reasonable commissions on the sale of stock are an admissible asset, inasmuch as they may not be deducted from gross income (T. B. R. 40).

(2) The portion of the capital surplus account which represents realized appreciation (i. e., the excess of allowable depreciation deductions based on 1913 valuations over similar computations based on cost) may be included in invested capital. However, the entire amount has been excluded, since the problem is silent on depreciation provisions.

(c) *Computation of tax payable:*

The tax payable may be computed according to the formula applicable to cases in which the invested capital exceeds $71,428.57 and the net taxable income is more than 20% of the invested capital, as follows:

Formula: 46% income — 5.04% invested capital — $740.

Solving:

46% income		$2,352,900.00
Less—5.04% invested capital	$349,067.22	
Specified exemption	740.00	349,807.22
Tax payable		$2,003,092.78

Question 2:

A company was incorporated as of January 1, 1920, to take over certain mines. The properties had been operated for some time by a receiver, the bondholders having bid in the properties at a foreclosure sale through a committee which turned over the properties to the new company.

The plan of reorganization provided for the issuance to the bondholders of the old company of $1,000,000.00 preferred stock and 10,000 shares of common stock of no par value of the new company, being its entire capitalization. An arrangement was made whereby the stockholders receiving such securities returned to the treasury of the new company as a donation 2,500 shares of common stock, with the understanding that such shares should be issued to the president for services to be rendered during the next five years, delivery of such stock to be made to him 1/5 at the end of each year.

The properties and assets acquired by the new company were as follows:

Mines and fixed properties	$1,800,000.00
Current assets	300,000.00
	$2,100,000.00
Less current liabilities	200,000.00
Net assets	$1,900,000.00

(1) Prepare an opening entry to record the acquisition of the properties and capitalization.

(2) How would you treat the 2,5000 shares donated by the stockholders?

(3) How would the accounts of the next five years be affected by delivery to the manager of 1/5 of such donated stock at the close of each year?

Solution, Question 2:

(1) Opening entry:

Mines and fixed properties..........	$1,800,000.00	
Current assets	300,000.00	
Current liabilities		$ 200,000.00
Capital stock preferred..............		1,000,000.00
Capital stock common—no par value.		900,000.00

To record acquisition of assets and assumption of liabilities of the —— Company in receivership and the issuing to the bondholders in control of said company the following stock for the net assets:
10,000 shares preferred—par 100
10,000 shares common—no par

(2) Treatment of donations:

Treasury stock—common	$225,000.00	
Capital surplus		$225,000.00

To record donation of 2,500 shares of no par value stock to be paid to president for services, at the rate of 500 shares a year for 5 years.

(3) An entry should be made at the close of each year charging salaries and crediting treasury stock $45,000.00.

The charge should be made to salaries and not to capital surplus, because the president's salary is an operating expense—the fact that it is paid in assets which have been donated is immaterial. The two transactions are distinct. The gift is an extraneous affair not related to operations. The salary is an operating charge affecting the operating surplus.

It might seem that the entry each year should be made at the value of the stock on the various dates instead of at $45,000.00. Suppose, for instance, that earnings of $150,000.00 have been credited to the capital stock common account at the end of the first year. The value of the outstanding common stock would be (assuming that preferred dividends have been paid):

Capital stock common:

Paid in	$ 900,000.00
Earnings	150,000.00
Total	$1,050,000.00
Less treasury stock	225,000.00
Net	825,000.00
Add capital surplus	225,000.00
Value of 7,500 shares outstanding....................	$1,050,000.00
Value per share of outstanding stock..................	140.00

If an attempt were made to make the entry for $140.00 x 500, or $70,000.00, the debit to salaries would be offset by a credit to treasury stock of $45,000.00 and a credit to surplus of $25,000.00. The extra charge to salaries and credit to surplus would offset each other without accomplishing anything. While the president would receive securities worth more than $45,000.00, the extra value is not paid by the corporation, but is the result of, or rather results in, a reduction of the book value of all common shares to an amount less than $140.00.

INCOME TAX AND BONUS

On pages 231 to 234 of the September, 1920, issue of THE JOURNAL OF ACCOUNTANCY there appears a letter from a reader of the *Students' Department* explaining a short method of computing the amount of a bonus to be paid to an employee of a corporation when the federal income and excess profits taxes are to be considered an expense before arriving at the basis of the tax. One sentence of this letter is misleading and should be corrected. This sentence is on page 233, and reads as follows:

"When the bonus comes out of the 40% bracket the amount of the bonus before figuring taxes plus 4.8217813% of itself will give the final bonus."

The sentence should read as follows:

"When the bonus comes out of the 40% bracket, the amount of the bonus after figuring taxes as though the bonus were not an allowable deduction, plus 4.8217813% of itself will give the final bonus."

Pace & Pace, New York, announce that Charles T. Bryan has been admitted to the firm.

August J. Saxer announces the removal of his office to suite 802 La Salle building, St. Louis.

Edward Clifton Smith announces the removal of his New York office to 15 Park Row.

Charles Frost announces the opening of an office at 1482 Broadway, New York.

George K. Hyslop announces the opening of an office at 42 Broadway, New York.

William Topper announces the removal of his office to 29 Broadway, New York.