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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

[Opinions expressed in THE JOURNAL OF ACCOUNTANCY are not necessarily endorsed by the publishers nor by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors.]

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No. 1

EDITORIAL

Group Meeting of Institute Members

An interesting experiment was inaugurated in New York on December 6th when a group of younger members of the American Institute of Accountants assembled at the Hotel Astor to study and discuss the general subject of preparation of accountants' reports. This was the first of what will probably be a series of meetings. It was frankly a trial balloon. If the plan meets with approval and is found helpful by those who participate in the meetings it may become a permanent feature in the activities of the Institute. It must not be confused with the students' societies which play so important a part in the preparation of men for accounting examinations in Great Britain. This is intended rather to provide an opportunity for a free and deliberate discussion without teachers and without scholars. The papers on December 6th were read by three members of prominent accounting firms, and about forty men who are members of the Institute were present. There was no intention to make this a general meeting of accountants both within and without the Institute; it was absolutely restricted to those who are already members of the organization. The purpose was to enable managers, seniors and, perhaps, semi-seniors to gather and discuss problems which could be expected to confront every one of them in the course of his professional work. The meeting followed in general the plan of round-table discussions which have become an attractive part of the annual meetings of the Institute. The administration of the Institute felt that the interest displayed

at annual meetings should not be limited to a meeting once a year but might be continued, wherever it was thought desirable, throughout the twelve months, with the exception, of course, of July and August and possibly January, February and the first part of March. If the experiment succeeds it will doubtless be followed by the establishment of similar groups in the principal centers of professional activity such as Boston, Chicago, San Francisco and elsewhere. At the meeting in New York there was an evident recognition of the value which may attend informal discussion, and plans are being made to continue the meetings in the spring as soon as the worst part of the winter rush is over. The group elects no officers, has no by-laws and takes no definite action. It is merely an assemblage of men with a common interest to discuss matters of common importance.

Desirability of a Natural Business Year

Perhaps no question which arises in the practice of accountancy has a more general appeal than the problem of distributing the work of an accountant's office over the whole year, so as to prevent the hills and valleys of activity which entail a great deal of inconvenience and prevent that even continuity of work which is the best assurance of efficiency. The American Institute of Accountants has always realized that the seasonal nature of accounting practice is one of its worst draw-backs, and there have been many efforts to encourage business men and others to adopt fiscal years most suitable to their individual trades or industries. The concentration of fiscal years of many of the industries and businesses of the country at December 31st is due to two or three fundamental causes. In the first place most people grow up from youth with an idea that December 31st is the only end of a year and anything which differs from the established calendar is a departure of doubtful merit or even validity. So, although the end of December may be the most inconvenient moment in the whole year to close the books, it has been the common practice to follow the calendar blindly. Lately came the tax laws, the first of which would not permit anything but a calendar-year closing, and it was only after strenuous efforts that the laws were amended to permit each business entity to adopt any fiscal year which seemed to it the most suitable. There was, however, a great deal of inertia among business men, and some of them were inclined to think and to say that nothing except a

benefit to the accountant could be gained by adopting a natural business year. This feeling, that accountants would be the beneficiaries of a change, has probably had as much as anything else to do with the still prevalent adherence to December 31st. As a matter of fact, however, the accountant is only one of the many who will be assisted by allowing business to follow its natural course. All tax-collecting offices, whether in nation, state or city, would derive still more advantage from an even distribution of the work. The saving to business men themselves would be a substantial item. Take, for example, the case of a department store which in the latter part of December has just passed the highest peak of its business for the whole year. It is an expensive undertaking to close the books, take inventory and do all the other things which are incident to the termination of a business year when the store itself can not possibly handle the work without a great deal of additional assistance. On the other hand, by waiting until January 31st the position will be greatly changed and the regular staff of the bookkeeping department can do what is required of it at less expense and with a far better probability of accuracy. Uneven distribution of work of all kinds is eminently undesirable, and it seems to us that any economist, business man, banker or accountant, if he will give the matter due consideration, will find himself convinced that everything possible should be done to bring about an even plane of work.

**Efforts to Induce
Reform**

The American Institute of Accountants has taken a leading part in an effort to encourage the adoption of the natural business year. An organization known as the "natural business year council," with offices in the building of the American Institute of Accountants, New York, has been formed. The council consists of fourteen men selected from the American Institute of Accountants, American Management Association, American Trade Association Executives, Dun and Bradstreet, National Association of Credit Men, National Association of Cost Accountants, New York Credit Men's Association, Robert Morris Associates and Trade Association Executives in New York. This group has prepared a basic statement, "The natural business year as the proper fiscal period," and a nation-wide campaign is being organized which it is hoped will impress upon business men generally the fact that adherence to anything but a natural business year is

expensive, unsatisfactory and injurious to all concerned. The council which has been formed has an important task to accomplish and it should receive the support of all accountants as well as other men concerned in business. There is, however, something more which is needed. The council will not accomplish its purpose if the members of the various organizations which are interested in it fail to exercise their own personal influence in bringing about reform. The effort will fail if those who should assist are content to let all the work be done for them without doing something for themselves. Let us take the accountant as an illustration. No one has more influence upon the policies of a corporation than the accountant, who is consultant and advisor as well as auditor. If in season and out of season the accountant will endeavor to convince his clients that those of them who have not yet adopted the natural year for the closing of their books are losing a chance to improve their organization and to increase their profits the movement will spread with great rapidity. An accountant reported the other day that one of his partners, who had devoted a great deal of time to encouraging adoption of the natural business year, had been instrumental in the past few months in converting twelve clients to the theory of the natural year. This was no doubt an exceptional case, but every accountant can do something to impress upon the men with whom he comes in contact that the natural business year should prevail.

**S. E. C. and Stock
Exchange Practice**

At a recent meeting of the Illinois Society of Certified Public Accountants, Geo. L. Tirrell, chief examiner for the committee on stock list of the New York stock exchange, spoke upon the subject of financial reports required under the securities exchange act of 1935. He drew attention to the fact that under the act financial reports must contain full disclosure of the elements included in the income accounts. The New York stock exchange adopts a different policy, and requires its listed companies to give the investor a fair and comprehensible conclusion and statement of affairs without the necessity for expert analysis of all the items in the income and surplus accounts. Mr. Tirrell said in part,

“In its own experience with its listed companies the exchange has striven for soundness of accounting principle as well as fullness of information and accuracy of figures. In fact, it has empha-

sized as of primary importance that public statements of earnings which include sums which do not represent true earnings are not to be excused by disclosure. Where results shown are clearly based upon unsound principles, the exchange has insisted upon changes in the methods of accounting. Where the principles involved are debatable and accounting opinion appears to be divided, the exchange has in most instances expressed a preference, but has not laid down a requirement. In all such cases it insists upon full disclosure of methods employed.

“During the comparatively few years covered by the expansion or boom period in the last decade and the depression period, corporate business has undergone more changes than during any other similar period of corporate history. Changes are still going on, both in business itself and in the legislative efforts looking toward control and regulation. The profession of accountancy is undergoing a marked development of its standards and practices. It would not be possible, and it would certainly not be desirable, to attempt during a period of such rapid and deep-seated changes to lay down a complete set of fixed principles which would govern methods of accounting for American business.

“The exchange can therefore question matters of accounting principles employed to greater advantage than can the commission, both because of limitations in the law itself and because it would not be a sound policy to give the weight of law to decisions upon matters of this nature, thus crystallizing principles that are in course of evolution along sound lines.”

Accountants will welcome this clear comparison of the requirements under the securities exchange act and under the rules of the stock exchange. It must be confessed that the latter system is apt to present a more intelligible picture of condition than could an absolutely fixed standard which all reports must follow. The accountant has continually to bear in mind the fact that the average reader of a balance-sheet or other financial statement can not be expected to be as expert as an accountant in understanding the technical presentation. It is equally important, however, that the investor recognize that it is impossible to reflect all of the complex elements affecting the value of an investment in a few brief, highly-summarized statements. In the sort of statement required by the stock exchange accountants can render important service, because of their knowledge of what the figures mean, to all investors and to the general public. This is one of the many ways in which the accountant of today can assist in the development of bettering financial reporting. The work which has been done by committees of the American Institute of Accountants in collaboration with the New York stock exchange

is one of the most satisfactory accomplishments of the profession in recent years.

**Contingent Fees in
Great Britain**

Readers of THE JOURNAL OF ACCOUNTANCY will probably remember that the question of contingent fees has been a frequent topic of discussion in these pages. There has always been a question as to the desirability of permitting members of the Institute to undertake accounting work the fee for which would be contingent upon results. Those who have advocated the acceptance of contingent fees have almost always based their argument upon the contention that claims for refund or abatement of taxation should be regarded as an exception to the rule and should not be prevented. On the other hand, the rules of conduct of the Institute specifically prohibit a contingent fee of any kind whatsoever. It has been alleged truly that American lawyers are not forbidden to undertake legal work upon a contingent basis; but, on the other hand, those who oppose all fees of that sort have referred to the rule of the English bar which is in exact harmony with the rule of the American Institute. No English lawyer is permitted to undertake a legal engagement on the understanding that his fees shall depend upon the success or failure of his efforts. Now it appears that the sentiment in opposition to contingent fees is not restricted to the United States. *The Accountant*, London, of August 17th quotes a resolution by the council of the Institute of Chartered Accountants in England and Wales which reads as follows.

“Resolved: that in the opinion of the council it is highly undesirable that in revenue cases members of the Institute should be remunerated by a percentage on the amount recovered or that they should receive no remuneration if no recovery results. Should such a case be brought to the knowledge of the council it would be liable to be regarded as discreditable conduct.”

**Canadian View of the
Matter**

Our able contemporary, *The Canadian Chartered Accountant*, in its issue of December, 1935, comments upon the resolution of the English institute and says in part:

“While no reasons were published it may be assumed that owing to the unfavorable impression which might easily be received by the public following a certain court action there respecting accountants’ fees the institute believed it in the public interest and in the interest of members of the profession to define its stand in this way . . .

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“Though it is the second case of its kind on record in Great Britain, the other being reported in *The Accountant* of 5th July, 1930, it can not be assumed that the practice was ever condoned by the profession there. When the case of five years ago was being heard, F. W. Pixley, F.C.A., an outstanding member of the English Institute, was called as a professional witness and on being asked ‘What do you say is the position with regard to payment by results?’ he replied ‘That is a matter that has come up on several occasions at meetings of the council and, from remarks I recollect having heard, members consider it is unprofessional to accept any matter of business on payment by results. We do not think it is a proper thing to do.’ The leading opinion of the accountancy profession in Great Britain, then, is that the system of payment by results is an undignified and unprofessional method of charging for professional services, and the prompt action taken by the Institute in England and Wales on the recurrence of the practice has served to clear up any possible misunderstanding on the part of the public in that country in regard to such practice.

“As far as we are aware no situation similar to this has come up for consideration by the profession in Canada, nor is it, we think, likely to arise here, since the rules of professional conduct adopted at the annual meeting of the Dominion Association of Chartered Accountants two years ago, and now embodied in whole or in part in the by-laws of most of the provincial institutes, make it quite definite that such a basis of remuneration for professional services is contrary to the ethics of the chartered accountant. ‘No member shall render or offer to render professional service the fee for which shall be contingent upon the findings and the results thereof,’ is the wording of the rule, and we also note that it is one of the rules of professional conduct of the American Institute of Accountants.”

We see, therefore, that although Great Britain is justly regarded as the birth-place of modern professional accountancy, it remained for the American Institute of Accountants first to prohibit contingent fees and that this action was followed by the Dominion Association of Chartered Accountants. Now the English Institute in the resolution which we have quoted has taken a definite stand which makes the rule against contingent fees of world-wide significance and effect.

What is Borrowed Capital?

Act number 10 of the extraordinary season of 1935 of the legislature of Louisiana levies a franchise tax on corporations doing business in that state. Section two of the act reads as follows:

“If the capital used or invested in the business or enterprise of such corporation includes borrowed capital in excess of its capital

stock, surplus and undivided profits, such excess of borrowed capital shall be added to the capital stock, surplus and undivided profits as part thereof as the basis for computing the franchise tax under this act."

There is no generally accepted definition of the term "borrowed capital" and there will probably be wide differences of opinion as to what should and should not be included under that designation. If the act is to stand and be the basis of administration of a franchise tax it will be necessary to define very definitely what is borrowed capital. The necessity for such a definition was strikingly evident in a recent law suit in the district court of Orleans parish where the computation of the franchise tax was involved. A witness in that case defined borrowed capital as follows:

"Liabilities of a corporation which are not temporary or current, but are of the following character, to wit:

Bonds.

Mortgages, including assumptions.

Matured interest unpaid.

Notes given in renewal in whole or in part or in settlement of accounts payable.

Such part of a temporary or current loan as is not paid when due.

Sums furnished by parent and affiliated companies or others regardless of the age or character of the debt, which are inconsistent with the borrowers' ability to pay currently through collections or earnings.

Taxes which are not paid at date of delinquency.

Declared dividends which are not paid when due.

Accounts payable past due beyond the terms of purchase."

There is excellent reason to question the definition which we have quoted. For example, bonds, mortgages, notes and advances from parent companies may be borrowed capital, but it requires a great stretch of imagination to convert notes and accounts payable, taxes, etc. (which are current liabilities) into borrowed capital the moment they become past due. The creditors to whom they are due would certainly not regard these items as a loan but rather as evidence of inability to meet obligations. The words "lend" and "borrow" seem to us to imply a willingness on the part of both participants in the transaction. The items mentioned might be described as involuntary loans but they are certainly not borrowed capital in the ordinary acceptance of the term.

Editorial

Lowest and Simplest A correspondent sends us a post card which was apparently addressed to every accountant in one of our great cities. It reads:

“What is the lowest price you can make on the simplest possible form of audit and oblige.”

At first glance this request looks ridiculous, but in reality it indicates nothing more than a total lack of understanding of audit. We doubt if the company from which it emanated would write to a lawyer and ask the lowest price for the simplest form of contract or to an architect for the lowest prices for the simplest possible form of building, yet it is quite as absurd to put such a proposal before an accountant. The best answer to the inquiry would have been a suggestion that the inquirer indicate what he means by audit. Does he mean anything at all? Accountants are ready to smile at some of the communications of this general sort which they receive, but the whole thing is due to a lack of knowledge on the part of the public, and it must be admitted that much of that lack of knowledge may be laid at the door of accountants themselves who have not taken the trouble to impress upon their friends and acquaintances accountancy's professional character, its advantages and its probable accomplishments. It is a long, hard climb to professional heights and it can not be done by blatant self-advertisement. We believe that no accountant should advertise himself directly or indirectly, but that every one whose interest is in accountancy could do something to teach some other man what accountancy is.

An Important Series of Articles It has been the practically unbroken custom of THE JOURNAL OF ACCOUNTANCY to publish, in the months immediately following the annual meetings of the American Institute of Accountants, the principal papers read at such meetings. This year one of the papers was not published in its original form because it was hoped that the author would consent to elaborate his ideas for later publication. Fortunately this hope has been realized and we publish this month the first of a series of three articles by George O. May, based upon the summary which he presented at the annual meeting. The second and third articles

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will appear probably in the February and March issues. We direct special attention of readers to this series of articles which we believe constitutes a most important contribution to the current literature of accountancy.

The Influence of Accounting on the Development of an Economy

BY GEORGE O. MAY

INTRODUCTORY

The series of articles of which this is the first constitutes an expansion of a paper under the same title which I read before the annual meeting of the American Institute of Accountants in October last. That paper fell naturally into three parts, each of which I propose now to make the subject of a separate article. Inasmuch, however, as there is a certain inter-relation between the parts, it seems desirable at the outset to indicate briefly their scope.

The first deals with the question how accounting can influence the development of an economy, which involves some consideration of the nature and purposes of accounting. The second will discuss the accounting practice in the treatment of gain or loss on the sale of capital assets and some of the economic effects of such accounting and of the habit of thought which it reflects. The third will be devoted to a historical consideration of the accounting treatment of the exhaustion of property in the course of operation, in the case of railroads and public utilities, and a discussion of the effect of the accounting theories adopted upon the growth of the capital equipment of the United States.

I. THE NATURE OF ACCOUNTING

Growing recognition of the importance of accounting is bound to result in closer examination of the relation between accounting and economics, a subject that has not as yet received very extended consideration. Professor John B. Canning, in his *The Economics of Accountancy*, suggests that the accountant's approach to problems is similar to that of the economist, but there is little to suggest that the course of accounting has been consciously influenced to any considerable extent by economic thought. The fact is, rather, I think, that accounting is a tool of business, and that the development of accounting, like the development of business law, has been determined by the practices of business men.* Where accounting and economic thought are

* This being so, the subject of this paper is, I recognize, merely one phase of the broader question of the effect of business practice on economic development.—G. O. M.

found to run along parallel lines, it is probable that both will be found to be running parallel to good business practice. Where accounting treatment diverges from economic theory, a similar divergence is likely to be found between economic theory and business practice.

To many persons, even in the business and financial world, the first question which our title would suggest is: How can accounting have any effect upon the development of a national economy? "Is not accounting," they would ask, "the application to particular facts of certain definite rules which can produce only one result?" Such a misconception of the nature of accounting is, I believe, less general today than it was a few years ago. During the last five years much has been done to secure recognition of the fact that accounting is not exact and rigid but is based very largely on convention and judgment. To the necessary work of education on this point the New York Stock Exchange and the Securities and Exchange Commission have made important contributions.

The regulations of the Commission have followed the policy adopted by the Exchange in allowing registrants to follow their own methods of accounting, provided that those methods were not obviously unacceptable and were clearly disclosed. I have understood that objection was offered to this proposal on the ground of its novelty, and it was, therefore, with particular interest that I read an editorial brought to my notice, in which this principle was referred to many years ago, almost as a truism. The editorial appeared in the *Morning Chronicle* of London in 1849, when the question of railway accounts was being widely agitated and was under consideration by a select committee of the House of Lords:

"What are the precise criteria which distinguish revenue from construction charges it is no easy matter to determine. . . . At present there is great room for controversy, but this, at least, will be generally agreed to, that the principle adopted by any company in the distribution of its expenditure between the two accounts is of comparatively minor importance, provided that the system pursued be distinctly avowed and understood by the shareholders."

The English courts, in decisions under the income-tax law, have repeatedly taken the view that what is profit is to be determined by the practices of business men. Moreover, as I have pointed

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out on other occasions, our own tax law has since 1918 laid down the rule that taxable income is normally to be determined "in accordance with the method of accounting regularly employed by the taxpayer in keeping his accounts," and this language remains on the statute book, although it must be admitted that the Bureau of Internal Revenue has done its best to make it nugatory.

So today it is, I think, clear that upon both principle and authority, accounting must be regarded as a process involving the recognition of custom and convention and the use of judgment, rather than as the application of rigid and unvarying rules. It follows that rules may, and sometimes must be changed as conditions change. This is of course true of law; and it may serve to emphasize the point in relation to accounting if I refer here to certain legal decisions on an accounting question with which I expect to deal in a later article.

In 1876, the Supreme Court said that the public "rarely ever took into account the depreciation of the buildings in which the business is carried on," and in 1878 it supported the government in its claim that a railroad company should not be allowed to include a depreciation charge in operating expenses, holding that "only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings." In 1909, however, we find the court saying: "Before coming to the question of profit at all, the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life." *

Now, once it is recognized that accounting is largely a matter of convention, it is easy to perceive that the nature of the conventions adopted may greatly influence the development of an economy. This is particularly apparent under a system of free enterprise, under which the hope of profit is the main reliance for the upbuilding of the industry of the community; for what is profit in the commercial sense here involved is not only an accounting question but is, indeed, the central question of modern accounting.

In the simplest forms of organized life, accounting problems arise, and the way in which they are decided influences action. The administrators of even a non-profit institution—a club, for

* *Eyster v. Centennial Board of Finance*, 94 U. S. (1876); *U. S. v. Kansas Pacific Ry. Co.*, 99 U. S. 459 (1878); *City of Knoxville v. Knoxville Water Company*, 212 U. S. 13 (1909).

instance—are called upon to account to its members. Shall they limit the accounts to actual receipts and disbursements? Must they not at least exclude or deal separately with borrowings and repayments; and if they ignore unpaid bills, may there not be a temptation to delay payments that ought to be made in order to present a more favorable showing? If bills owing by the club but unpaid are to be brought into account, should amounts owing to the club also be taken into consideration? In technical language, should not the account be one of income and expenditure rather than one of receipts and disbursements? Taking a further step—in order to reduce the cost thereof, insurance has been written for three years; should the whole cost be charged against the one year and the next two years be relieved of any corresponding charge? Or, an automobile has been bought—should the cost be charged against the year or distributed over the probably useful life of the car? Speaking technically again, should not some accrual basis of accounting be employed?

From this example, it is easy to see how considerations of policy may influence accounting, or how the form of accounting may influence the course of events. One form of accounting may show a balance for the year in favor of the club, with the result that the dues may be left unchanged or even reduced; another might show a balance against the club and lead to an increase of dues. Reluctance to put an increase in force may lead the administrators to choose the method which gives the seemingly more favorable result. Indeed, to leave bills unpaid at the end of an administration, thus unfairly relieving the accounts of the outgoing and unfairly burdening those of the incoming administration, is a well-known device of dishonest politicians.

Apart from such crude devices as this, what would have been the effects if our municipalities had adopted the accounting practice of providing for future pensions in the years in which the service which gave rise to the right thereto was rendered? It is by no means abnormal that the actuarial value of the pension benefits attaching to municipal employment should be equal to twenty per cent. of the nominal compensation of the employee. If, therefore, municipal budgets provided currently for the deferred compensation as well as for that immediately paid, and if the present value of the future liability were treated as a part of the indebtedness of the municipality, both the budgets and the borrowing capacity of the municipality might be very largely

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affected. In the city of New York, some of the funds are maintained on at least a quasi-actuarial basis, while in other cases no provision is made for future liabilities, the present value of which today runs into several hundred millions of dollars. As against the advantages of a more accurate disclosure of the costs of government and of the financial position of a municipality which would be derived from the inclusion of the provision for deferred-pensions liabilities, there would no doubt have to be considered the possibilities of abuse that would be created if funds to meet such liabilities were currently set aside and entrusted to city officials for investment in order to provide for the obligations as they become due.

The most important group of problems which the accountant has to consider relates to the distinction between capital and income. In some cases, the question is whether amounts receivable or payable shall be carried once and for all to the income account or to the capital account. In other cases, the issue is how and when amounts which have been carried in the first instance to the capital account shall be transferred to the income account.

At this point it seems desirable to emphasize the fact that accounting is not essentially a process of valuation, as some writers on accounting and some economists conceive it to be. Professor C. R. Rorem's book, *Accounting Method*, seems to me to suffer from this misconception, and it is hardly too much to say that Professor Canning's book (to which I have already referred) is built up on it. Primarily, accounting is historical in its approach, with valuation entering into it at times as a safeguard. The emphasis is on cost, though where an asset is intended for sale and its selling value is known to be less than cost, the lower figure may be substituted for cost. The outstanding illustration of this practice is the almost universal custom of valuing goods on hand at cost or market, whichever is lower.*

Capital assets, in particular, have traditionally been recorded by the accountant at cost or at cost less deduction for depreciation. To the accountant it has seemed to be neither a practicable nor a useful undertaking to attempt to determine the value of assets not intended to be sold and for which there is no ready market, especially as the concepts of value differ; (and it has been said that in one English act the word "value" is used in twenty-seven different senses†). If the accountant accepts the economic

* Incidentally, the growing emphasis on the income account as an index of earning capacity, and hence of capital value, may make desirable some modification of the treatment commonly adopted in this matter.—G. O. M.

† See *Proceedings of the International Congress on Accounting*, London, 1933, p. 135.

measure of value as being the discounted value of a prospective income stream, it seems to him futile to attempt to reflect fluctuations of the income prospects and the discount rate on the books of a corporation which has no thought of attempting to realize its capital or of doing anything except receive and deal with the income stream as it comes in. He would rather concentrate on the more useful task of measuring—with what accuracy is attainable—the income stream as it flows.

True, during the 1920's, accountants fell from grace and took to readjusting capital values on the books of companies to an extent never before attempted. In extenuation, they might plead that unsound laws, unpractical economics, and a widespread if unfounded belief in a new order of things combined to recommend such a course, but the wiser policy is to admit the error and to determine not to be misled into committing it again.

The accounting function in relation to capital assets is to measure and record not the fluctuations in their value but the extent to which their usefulness is being exhausted through age or use, and to make proper charges against income in respect of such exhaustion, based on the cost of the property exhausted, with the intent that the property shall stand on the books at its salvage value when the term of its usefulness is ended. Conversely, when money is borrowed to be repaid at a premium (as, for instance, when a bond is sold at a discount), the amount borrowed forms the basis of the accounting, with sums added thereto and charged to income periodically as the obligation is maturing, so that at maturity the full amount repayable will stand on the books as a liability.

In practice, two accounts are frequently used in dealing with either capital assets or capital liabilities. In the case of an asset, one will record the original cost and the other the accumulated provision for exhaustion. In the case of a liability, one will record the ultimate amount repayable and the other the proportion of the discount which is carried forward to be charged against the unexpired period of the loan; but this subdivision of the account into two parts is merely a technique employed for the sake of convenience.

The fact that cost rather than present value is thus commonly used in the accounting upon which published balance-sheets are based is by no means universally recognized; and, when recognized, it is sometimes criticized on the ground that the main

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purpose of a balance-sheet is to enlighten the investor, and that what the investor is interested in is the value of property, not its cost. The misunderstanding and the criticism are so common, and reflect so many disputable assumptions, that it seems desirable to discuss them briefly.

The misunderstanding appears to arise mainly from the looseness in the use of language which is responsible for so much of the existing confusion of thought in relation to accounts. I have already alluded to the fact that in a single act of the English parliament the word "value" is alleged to have been used in at least twenty-seven senses, and it would certainly not be difficult to match this record in our own experience.

Any thoughtful student of finance must have been struck by the fact that one constantly encounters the word "value" with a qualifying adjective attached to it which in every case limits and in some cases negatives the meaning of the noun. Thus we have the phrases—"book value," "cost value," "replacement value," "assessed value," "going concern value," "liquidation value," "market value," "intrinsic value," "fair value," "sound value," "discovery value" (perhaps the most fantastic of all), etc., etc. Almost any asset will be found to be stated in the balance-sheet at one or other of these so-called values.

These expressions, no doubt, have a certain usefulness, though in some instances the concept they are used to describe is remote from the concept of value. The real trouble is, that since the word "value" forms a part of each phrase, and since all of them represent things that are expressed in money, essential dissimilarities in their significance are apt to be overlooked. Hence people who would not dream of adding together a cart-horse and a saw-horse and speaking of the result as two horses, have no compunction at all about adding together a book figure (or, as they call it, a book "value") and a market value, and speaking of the result as a "value," even in the case of a stock the selling price of which is a mere fraction of that "value." Oscar Wilde defined a cynic as a man who knew the price of everything and the value of nothing.* It would be well if some of those who talk glibly of value would develop enough cynicism to keep the test of salability (and earning capacity) more constantly in mind.

* "Cecil Graham: What is a cynic?"

Lord Darlington: A man who knows the price of everything and the value of nothing.

Cecil Graham: And a sentimentalist, my dear Darlington, is a man who sees an absurd value in everything and doesn't know the market price of any single thing."

Lady Windermere's Fan, Act III.

The fact is that the word "value" has come to be used to describe what is often really a mere figure—"book figure" would be more accurate than "book value," and the "figure" at which an asset is carried more accurate than the "value" at which an asset is carried. It must be admitted that accountants have themselves some responsibility for the misunderstanding that exists, and academic writers, regulatory bodies and appraisers have also largely contributed to it. However, what has come to be called "wishful thinking" is probably mainly responsible for it. The transition from the thought that it would be convenient and helpful if balance-sheets did represent realizable values to the thought that they do has been all too easy.

A similar misunderstanding is not altogether uncommon in England, though there is little or no real justification for it there. In the case of railroads and public utilities, to which what is known as the "double account" system has applied (as prescribed, for instance, in the Regulation of Railways Act of 1868), capital assets have not appeared as such in any balance-sheet—instead, the expenditures thereon have been recorded in a statement of receipts and expenditures on account of capital, only the balance of which has entered into the general balance-sheet of the company. In the case of companies incorporated under the general incorporation law, the model balance-sheet embodied in Table A of the Act of 1862 contained an instruction in respect of not only capital assets but also stock in trade, reading as follows: "The cost to be stated with deductions for deterioration in value as charged to the reserve fund or profit-and-loss account." I have even seen an opinion by eminent counsel, now on the English bench, to the effect that it was no part of the purpose of a balance-sheet to reflect the values of assets, though directors might, in their discretion, see fit to embody in it information which would throw light on those values.

Turning now to the objection that if balance-sheets do not reflect values they ought to do so, because that is what the investor is interested in—a number of minor exceptions to the position thus asserted might be taken, but the answer to the objection is that it is utterly impracticable to ascertain the values of capital assets in the case of businesses of any magnitude, and that the figures would be of no real interest to the investor if they could be ascertained. What the investor is actually interested in is, obviously, the value of his investment; and the objection therefore

presupposes that the value of an investment may be computed by adding up the values of the assets which represent that investment and deducting from the total any liabilities to which they are subject.

Now, only brief consideration is necessary to show that this assumption is valid in the case of a profitable business only upon the further assumption that the value of the assets essential to the business and not intended for sale is simply the difference between the value of the business as a whole and the realizable value of the assets which can be separately sold without sacrifice. By the hypothesis and, in fact, what the investor or speculator is interested in is the value of the business as a whole, and that is dependent mainly on what it will produce in the future and is not determinable by any purely accounting process. Not only so, but if the accountant were to assume the task of valuing the business as a whole, he would have met the assumed need, and it would be entirely supererogatory for him to attempt to allocate that value as between the different assets of the business.

How great the difficulties presented by such an allocation would be may be indicated by stating generally the character of the problem presented, as follows: "How shall we compute the value of a producing unit which has been in use for a term of years, assuming that another type of unit could be bought new today for substantially less than the cost of reproducing the existing unit and would effect an economy in operation; assuming, further, that there is a strong probability that still another type will be developed within a few years which will cost less and be more efficient than any now available, and making due allowance for the fact that the existing unit is in actual operation and that a period of time more or less considerable would be needed for the installation of a new unit?"

There may be other elements in the problem to be considered, but certainly any so-called valuation which ignores those I have suggested can not be claimed to represent the value of the asset. The easy solutions, termed "replacement values" or "sound values" beg the question. While it is impossible to say what percentage of the capital equipment of the country would be replaced even substantially where and as it is, it is quite certain that the percentage is small. It is well known, also, that correct timing of major replacements is one of the most important factors in determining whether a given industrial enterprise shall succeed or fail.

To carry consideration of the question one step further—inasmuch as the value of a successful business is dependent mainly on its earning capacity, it follows that to anyone interested in determining that value the greatest service which accounts can render is to throw light on earning capacity—not on the so-called values of assets which are not intended to be sold. And, so far as the records of the past can be an aid to the estimation of future earning capacity, an account which ignores fluctuations in the value of capital assets is likely to be far more useful than one that attempts to reflect them.

Accounts have other important uses, possibly not less important than that of throwing light on the value of the evidences of ownership in a business. The determination of realized profits, and of the income subject to taxation, and the presentation of fairly comparable statements of operating results for successive periods, would all be made more difficult and more complex if at the same time the accounts were being adjusted periodically so as to reflect the fluctuations in the value of the assets held for use and not for sale.

The canon of sound accounting, that fluctuations in the value of capital assets not only may but should be ignored, rests on surer ground and is more realistic than the contention that balance-sheets should aim to reflect values. In this, as in so many other fields, error has resulted from attempts at over-simplification. What the equation: "Assets minus liabilities equals proprietorship" and the phrase "net worth" gain in simplicity they sacrifice in significance. A balance-sheet, in which one asset is stated at book value, another at replacement value, a third at liquidation value and a fourth at going-concern value, and the liabilities at their face value, does not yield a figure that can be described as net worth expressed in a single measure of value any more than one in which were mingled American and Chinese dollars and Mexican and Chilean pesos all preceded by the same familiar dollar sign, could produce a net worth expressed in any one of those currencies.

Of those who decline to recognize the impossibility of determining capital value by the methods commonly proposed, few have suggested annual or anything more than periodical adjustment of the balances on property accounts to conform with so-called valuations. The Interstate Commerce Commission, while insisting on the need for valuation as a basis for a revision of the

property accounts of the carriers, has indicated quite clearly that once the revision had been effected it contemplated cost as the basis for all subsequent accounting, and it has treated as axiomatic the proposition that charges against income for property exhaustion should be based on cost.

The question may no doubt fairly be raised whether even if value is eliminated as a possible basis for arriving at the figures at which capital assets shall be carried (due allowance being made for exhaustion of useful life) there is any other basis which is preferable to cost. The alternative most favored is estimated cost of replacement; but while the usefulness of computations of cost of replacement for a wide variety of administrative purposes may be admitted, the regular use thereof as the basis for the restatement of the book figures is not, I think, one of them.

Any adequate discussion of this question would involve consideration of all the manifold purposes for which accounts are used and go far beyond the scope of such an article as this. In my judgment, however, it will as a rule be wiser to retain the virtues of continuity and reality in the book records which the cost basis affords and, in appropriate cases, to furnish to stockholders a supplementary statement based on replacement cost (which must in any event be hypothetical and ephemeral). Whatever course is followed, it is necessary to relinquish the hope that balance-sheets can be made to reflect the value of capital assets, if that word is to be used without any qualifying phrase that destroys the substance and leaves only the shadow of its meaning.

Cases will arise—as, for instance, that presented by a devaluation such as occurred in Germany—in which cost figures lose their significance to such an extent as to make some different treatment necessary, but such cases are exceptional and their existence merely emphasizes the fundamental importance of honest and competent judgment in accounting.

This does not mean that the balance-sheet is valueless, but only that it is a highly technical production the significance of which is severely limited and has in the past often been greatly overrated. In origin, the balance-sheet is an account; in England, it still commonly bears the headings "Dr" and "Cr" instead of the "assets" and "liabilities" to which we have become accustomed. These facts were recognized by the committee on coöperation with stock exchanges of the American Institute of Accountants in

its report to the New York Exchange of September 28, 1932, in which it included as among the objects which the Exchange ought to pursue:

1. To bring about a better recognition by the investing public of the fact that the balance-sheet of a large modern corporation does not and should not be expected to represent an attempt to show present values of the assets and liabilities of the corporation.

2. To emphasize the fact that balance-sheets are necessarily to a large extent historical and conventional in character, and to encourage the adoption of revised forms of balance-sheets which will disclose more clearly than at present on what basis assets of various kinds are stated. . .

3. To emphasize the cardinal importance of the income account, such importance being explained by the fact that the value of a business is dependent mainly on its earning capacity.

In recent years it has become increasingly apparent that for the large modern corporation, at least, the balance-sheet is not in itself an adequate supplement to the income and surplus accounts, and it is not surprising that the regulations of the Securities and Exchange Commission have called for additional statements. The schedules filed under those regulations, and the explanations which are commonly given in connection therewith, should do much to create a juster appreciation of both the significance and the limitations of a balance-sheet. There will still be those who will clamor for an unattainable combination of completeness, precision and simplicity and for a uniformity which would be superficial and illusory. The demand for predigested preparations which will meet all needs, without any exercise of selective judgment or intelligence, is encountered in the fields of accounting and finance as elsewhere.

Oil Inventories Accounting *

BY HOWARD S. THOMPSON

The subject of oil inventories is one which has caused, and still is causing, a great deal of controversy, both within the petroleum industry and between the industry and the accounting profession. For some time committees of the American Petroleum Institute and the American Institute of Accountants have been working closely together in the attempt to establish some formula with respect to inventories which will allow fair statistical comparisons between oil companies. The tangible results to date appear, however, to be quite insignificant, probably because the subject is such a broad and complex one and there are so many and various methods now in use.

There is relatively little accounting literature relating to the oil industry and such as there is does not, in my opinion, do justice to the subject of oil inventories. This may very well be for the reason that no one as yet has desired to take the responsibility of putting his name to a subject which has so many pitfalls, and I, myself, have no wish to rush in where wise men fear to tread. It is accordingly intended not to offer my opinions as definitive answers to the questions discussed, but rather to submit the problems in the hope that satisfactory solutions will be hastened by more extended thought and effort on the part of professional accountants generally.

PERMANENT AND SEMI-PERMANENT STOCKS

The many different problems which arise in accounting for oil inventories are so closely related to each other, and all have so many ramifications of their own, that it is extremely difficult to separate one problem from the others, and it is likewise difficult to discuss the general principles applying to any of them without becoming involved in a consideration of technical details. There is, nevertheless, one question which I think may safely be said to be more fundamental than the others but, unfortunately, has so far not received the attention its importance warrants, although it has been considered by some accounting officers of members of

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the industry and by some professional accountants; and it is now, I believe, being studied by the committees representing the two Institutes. This question relates to the large quantities of various petroleum products, in excess of normal current requirements, which are frequently carried by integrated oil companies and by many refining companies, and, at times, due to peculiar circumstances, by strictly producing companies.

The many causes for this condition may be indicated by a few illustrations. In the case of an integrated company or a refining company, it may be due either to the policy of purchases in the attempt to maintain stabilized market conditions, to the desire to accumulate adequate reserve stocks to protect future requirements, to inability to dispose of the excessive stocks or to a combination of these factors. In the case of a producing company holding a large quantity of crude oil in excess of current sales, this may likewise be due to the inability to dispose of the excessive stocks, or it may result from the expectation of higher prices. Physical conditions also have a considerable effect upon the quantity of petroleum products continuously included in oil inventories. For instance, where floating tank covers are used in order to minimize the losses from evaporation, the tanks having such covers can not be emptied below the point at which the descent of the floating cover is stopped without incurring some of the evaporation losses which the cover is designed to prevent. It is probable that the quantity of oil or other petroleum product in such a tank would not ordinarily be reduced to the point where the floating cover would be ineffective. Again, the use of pipe lines for the transportation of crude oil or refined products has the effect of "freezing" in the inventory the quantity of such products necessary to fill the pipe line. It is, of course, obvious that the same crude oil or other product does not remain in the pipe line, but, as the quantity in the pipe line remains practically unchanged, the principles concerned are substantially the same as those relating to petroleum products in tanks with floating covers.

Whatever may be the cause, it is known in many cases, and can be reasonably assumed in many other cases, that the inventories are in excess of normal current requirements. All accounting authorities seem to agree that a clear distinction should be made between current assets and other assets and that the classification of current assets should include only those which either represent

cash or are expected to be realized, in cash or the equivalent, within a reasonable length of time in the ordinary course of business. It may, therefore, be strongly urged that in the circumstances previously mentioned, the inclusion of an entire oil inventory among the current assets is definitely contrary to accepted accounting principles.

In order to reflect the oil inventories in the balance-sheet in accordance with the generally accepted principles of accounting, it is necessary first to determine the quantities and the valuation bases for the permanent or semi-permanent portions thereof and next to determine the proper classification for these more or less fixed portions. These two problems are very closely related and, in both, the difficulties of solution are by no means insuperable, once agreement has been reached on the general proposition that only the current portion of the oil inventories should be included in the current assets.

A survey, recently made of the economic inventory requirements of all refiners, pipe lines and terminals, indicates the somewhat surprising result that approximately two-thirds of the total composite inventories are to a considerable extent frozen. This percentage undoubtedly varies in individual integrated companies and refiners, but it is rather convincing evidence that a large portion of such oil inventories should not be considered as current assets. At least a few of the progressive oil companies maintain statistics relating to their expected current requirements and to the availability of various portions of their inventories for those requirements. In the absence of such statistics in a particular case, the quantities of crude oil and other products to be excluded from the current assets could be satisfactorily determined, under the general rule previously stated, that current assets are those expected to be realized in the regular course of business within a reasonable period.

It has been shown that specific oil may remain permanently in storage in tanks with floating covers, and that equivalent quantities may be permanently maintained in pipe lines, even though there is an actual physical change in the oil. Comparable conditions are frequently found to affect a substantial portion of the inventory. It is not unusual for the same oil to remain in the same tanks for a number of years, and even oftener the oil moved from storage tanks is immediately replaced by a comparable quantity of other oil. It accordingly follows that, where ade-

quate statistics are maintained by the accounting company, it is possible quite easily to determine, not only the portions of the inventory which are more or less fixed, but also to identify the particular quantities of oil belonging in that category. Where such identification is possible, it is helpful in establishing the price basis to be used in valuing this portion of the inventory.

If it is agreed that the fixed and semi-fixed portions of the inventory are to be excluded from current assets in the balance-sheet, the question of their proper classification is then presented. It may fairly be urged that the fixed quantities of oil, which must be permanently maintained in tanks with floating covers, in pipe lines and under other comparable conditions, are a part of the permanent investment which is necessary to ensure the most effective use of the physical equipment. Since these quantities usually are not, and in many instances can not, be sold or removed as long as the particular physical equipment is in use, it would follow that, to be strictly in accord with accepted principles of accounting, the values of these quantities of oil should be included in the fixed (capital) assets.

Next to be considered and classified is the oil which is carried as a reserve for future requirements. This oil is surely not a current asset and, although it is not fixed as an asset to the same extent as is the oil required to assist various items of physical equipment to fulfill their functions, it seems to me that it may reasonably be likened to the underground reserves of oil, the investments in which are, of course, included in the classification of fixed assets. It could, therefore, be decided with apparent propriety that the inventory of oil in reserve storage should also be reflected in the balance-sheet as a fixed (capital) asset.

In a different category is the oil which is held by reason of a market stabilization policy or the company's inability or indisposition to sell. Both of these conditions often exist in the case of an integrated company or a refining company, and both may also be present in the case of a producing company—although in the latter case the accumulation of inventory stocks is also frequently due to the expectation of higher market prices. Such oil is the most difficult of all to classify properly, and this difficulty is due to a large degree to the deficiencies and inconsistencies in our present accounting terminology, which has "justed growed" like Topsy. The oil in this category is certainly neither a current asset nor a fixed one, but what is it? It might be said to be a

deferred asset in the sense that its realization is assuredly deferred, although this classification has not been widely used for assets of any nature. On the other hand, this oil seems to possess the characteristics of a semi-permanent investment in a commodity, rather than in a security to which the balance-sheet designation of "investments" has customarily been restricted. It will thus be seen that there is now no existing classification in which to reflect, with entire satisfaction, the excess oil stocks resulting from market conditions. However, at the present time and until more clarity and elasticity develop in the terminology of accounting, I would be inclined to favor including the semi-permanent investment in inventory in the classification "investments" with the investments in securities.

The foregoing remarks are not quite as revolutionary as they may seem. It has already been said that these conditions are well known to officers of the industry and, although not perhaps for the same reasons which I have expressed, are nevertheless included in the matters which have been, and are still being, discussed between the committees of the American Petroleum Institute and the American Institute of Accountants.

METHODS OF ACCOUNTING FOR OIL INVENTORIES

The accounting problems relating to the subject of oil inventories start with the production of crude oil and increase in variety and complexity as the oil is refined and marketed. This condition can be indicated by the following questions, which must be decided in each particular case more or less arbitrarily, at the present time, on account of the absence of anything in the nature of a recognized practice.

Should the current posted market prices or the cost prices be used in valuing inventories of crude oil?

In running crude oil to stills should the "first in and first out" method, the average cost method or the "last in and first out" method be used?

Should the crude oil inventories be reduced to cost or market, whichever is lower, on the balance-sheet? If this is done, should the deduction be shown as a reserve account or as a credit to the assets?

Should the corresponding charge then be made in its entirety directly to profit-and-loss or to surplus with respect to the adjustment applicable to that portion of the inventories carried forward from a prior period?

The "last in, first out" method of valuation of petroleum inventories recommended by the American Petroleum Institute's committee on uniform methods of oil accounting, and adopted by the Institute's board of directors, appears to be an indirect attempt to solve some of the problems created by the existence of large permanent petroleum stocks. In the application of this principle it has been recommended that:

"Current costs of crude oil and products should be charged against current sales as long as inventory quantities remain approximately unchanged or sales are about equivalent to new acquisitions (production and purchases).

"In the costing of crude oil stock (inventory), current production and current purchases should be the first applied to current cost of sales and current operations . . .

"In the costing of product inventories, current purchases and current production should be the first applied to current cost of sales and current operations . . .

"In starting the 'last in, first out' inventory plan, the prices should be set at a conservative or reasonable figure. In the future, inventory prices should not be reduced to market prices, when lower than the regular inventory value. Where the market value of the inventory is less than that carried in the balance-sheet, such condition should be shown in parentheses or as a footnote in such manner that the approximate difference can be ascertained, either in dollars or percentage."

This action of the American Petroleum Institute was commented upon in an editorial in the March, 1935, issue of **THE JOURNAL OF ACCOUNTANCY** in which it was said that,

"There will be differences of opinion as to the accuracy of the method of valuing inventory which is recommended by the Petroleum Institute, and in recognition of this fact it has been arranged that deliberations shall take place between the accounting committee of the Petroleum Institute and the American Institute of Accountants' special committee on inventories. These deliberations should determine whether the principle of 'last in, first out' may be considered as acceptable and in consonance with sound accounting or, if there be a difference of opinion between the two committees, what alteration in the method of application of some such principle may be required to make it acceptable. There has been something resembling a tradition in favor of 'first in, first out' for ordinary merchandise inventory valuation, but it may be that there is something inherent in the inventory of commodities such as oil which will justify the principle which the Petroleum Institute now advocates. At any rate the question is of more than academic

importance and the two committees should be productive of something almost authoritative."

This editorial was unquestionably correct in stating that there would be differences of opinion as to the accuracy of this method, although I think that the weight of the argument would be adverse. If this procedure as recommended by the American Petroleum Institute's committee was an indirect attempt to solve the accounting problems created by semi-fixed inventories, as indicated by the Institute's explanation, it is my opinion that the solution not only does not solve the problem but creates an entirely erroneous situation. On the other hand, I am far from being in accord with the "first in, first out" method which is quite reverently referred to in the aforesaid editorial in THE JOURNAL.

There seem always to have been arguments, and there perhaps always will be, on almost every angle of inventory accounting, but on none more than on this particular phase. For some years I have favored the "average" method of accounting for the flow of commodities and their inventories, as I am convinced that better results are currently obtained under this method and that more satisfactory comparisons can be made as between periods. There are many situations in which neither the "first in, first out" nor the "last in, first out" rule can be applied for various reasons, and even in those cases where it is possible to use one or the other of them, I think that they are much less desirable than the "average" method, on account of the defects in the reasoning upon which they are based.

For example, suppose that in an 80,000-barrel-capacity tank there are 40,000 barrels of thirty gravity crude oil, purchased at the price of \$1.00 a barrel, amounting in the aggregate to \$40,000, and that subsequently 40,000 barrels of twenty-eight gravity crude oil are purchased at the price of \$0.90 a barrel, aggregating \$36,000. Assume for the sake of illustration that when the later purchase is run into the same tank and commingled with the previous quantity of thirty gravity oil, we have then 80,000 barrels of twenty-nine gravity oil, which cost a total amount of \$76,000, representing an average price per barrel of \$0.95. Thereafter 20,000 barrels of this twenty-nine gravity oil are sold from the tank. From which purchase was this oil sold? Was it from the thirty gravity oil purchased at \$1.00 or was it from the twenty eight gravity oil purchased at \$0.90? It is probable that under

these conditions the question could never be definitely answered and it would follow, therefore, that the use of either the "first in, first out" or the "last in, first out" method would necessarily be based upon a purely arbitrary assumption. In view of these circumstances, it is my belief that the "average" method more nearly accounts for what actually happens.

The following condition, although somewhat unusual, will further illustrate the point. A large oil company has a distributing depot in a portion of the world which is inaccessible during approximately six months of each year, and it accordingly must make deliveries to this depot during the remaining six months, say beginning with the first of April and ending with the last day of September. The sales made by this depot are relatively small during the period in which it is receiving supplies, and its major distributing operations occur from the first of October of each year to the last of March the following year. Would it be correct to say that the oil or other petroleum products sold from this depot during the month of October are those which it received during the period immediately preceding? Would it not be more correct to say that the inventory on hand at October first consisted of so many barrels of oil at an aggregate cost of so many dollars, and that therefore each barrel of oil sold from this stock should be costed out at the average price per barrel?

Nearly every oil company maintains a record of the physical movements of the various commodities and of their inventories. These movement records facilitate the application of any accounting method and any basis of valuation which may be used, but even with this assistance the "average" method is somewhat easier to operate than either the "first in, first out" or the "last in, first out." The example given with respect to a particular tank is not intended to indicate that the accounting for movements and inventories of products should in all cases necessarily be in such detail that each individual tank must be separately treated. The circumstances in each case will control, I believe, the extent to which detail accounting is required. It may therefore be stated as a general proposition, which is of course subject to modification in specific instances, that each separate group of tanks in the same location containing the same commodity, whether it be crude oil, gasoline, fuel oil or some other product, may satisfactorily be accounted for in the principal records as a unit under the "average" method.

It remains to be seen, of course, just how widely the "last in, first out" method will be adopted by the members of the oil industry, and a forecast naturally can not be made at this time as to the result of the deliberations on this question between the committees of the American Petroleum Institute and the American Institute of Accountants. It is to be hoped that whatever conclusion is reached will aid in gaining the ultimate end of fair statistical comparisons between companies.

METHODS OF PRICING OIL INVENTORIES

So closely connected with the problems relating to the current and non-current portions of oil inventories, and to the methods of accounting therefor, as to be virtually inseparable are the problems relating to the methods of pricing these inventories. The methods currently in use among members of the oil industry vary considerably, not only between various companies, but, in some cases, between different departments within a company in regard to the several commodities produced. These methods may, however, be broadly described as cost or market, whichever is lower, actual cost and expected realization. Each one of these methods has some advantages as well as some disadvantages which distinguish it from the others.

The cost-or-market-whichever-is-lower method is, I believe, subject to more objections than the two other methods, for its use has in the past years caused quite absurd conditions in the accounts and published reports of oil companies as a result of widely fluctuating market conditions. This circumstance was recognized by the American Petroleum Institute's committee on uniform methods of oil accounting when in connection with its recommendation of the "last in, first out" method, it also recommended that "in future, inventories are not to be reduced to market prices where such market is lower than a conservative or reasonable cost or inventory valuation. Where the market value of the inventory is less than that carried on the balance-sheet, such condition should be shown in parentheses or as a footnote in such manner that the approximate difference can be ascertained. This may be expressed in figures or percentage." I sincerely hope that this particular recommendation will be followed by oil companies generally.

There are a great many small producing companies, whose inventory at any date is not in excess of its production for a few

days, which follow the practice of reflecting their inventories at current posted market prices and do not attempt to compute their unit costs in order to conform to the cost-or-market-whichever-is-lower method. The straight market method of valuing inventories does, of course, result in the anticipation of profits at the end of any accounting period but, where the inventory is an insignificant factor and the practice is consistently followed during each accounting period, I do not think this procedure is subject to severe criticism.

I imagine that the majority of professional accountants would generally prefer to have inventories priced at actual cost. The term "cost" is, however, one of the most misleading words used in accounts. It is, I think, generally understood by accountants, and as generally not understood by laymen, that either a unit price or an aggregate amount which is stated to represent cost is not an actual demonstrable fact but is only the opinion of one person or a group of persons based upon the use of arbitrary factors. This is due to the requirement that, in attempting to value inventories at cost, the elements to be included therein and the bases for their inclusion must be determined. Inasmuch as this determination requires the use of at least some arbitrary factors, we thus preclude the possibility of ever arriving at anything that can be truly stated to be actual cost. These conditions render it extremely unlikely, if not in fact impossible, that within the petroleum industry, or even within the major portion of the industry, there can ever be obtained a costing formula or procedure that will make possible really close comparisons between companies.

The realization basis for pricing inventories seems to have been used to quite an extent in the valuing of finished by-products in accordance with the well recognized principle that expected realizable values of by-products, rather than their cost, may be properly applied as credits in determining the cost of the principal product. Although I think that this is quite an arbitrary procedure, it has, at least, the merit of simplicity. I do not know, however, of any case in which the realization basis has been applied to the principal product, and I doubt very much whether it could be satisfactorily applied to it.

In this brief discussion of the methods of pricing oil inventories, I desire to refer to still another method which has apparently not received the extensive consideration in relation to oil inventories

to which in my opinion its seeming advantages entitle it. This is the principle frequently referred to as "standard costs." During recent years the theories underlying this method seem to have received more and more favorable consideration in other industries, and it has features which seem to render it quite suitable for application to inventories of both crude oil and finished petroleum products. The standard cost of a product is the sum of the predetermined basic rates for the direct labor, materials and other charges entering into its production. This theory recognizes that all costing operations are to some extent arbitrary and, because of this fact, it starts with a complete arbitrary in contra-distinction to the procedure followed in the attempt to ascertain actual costs, where the arbitraries creep late into the costing procedure and are buried and often forgotten.

While the proponents of standard costs are apparently steadily growing, they seem to be divided into two schools of thought, one of which advocates the use of standard costs solely as a measure for comparison against actual costs, while the other school advocates the substitution, throughout the accounting records and financial statements, of standard costs in place of actual costs. It is not within the scope of this paper to discuss the relative merits of these two opposing opinions, but I do wish to point out that if there is sound accounting justification for the use of standard costs in place of actual costs this method might well be the answer to our prayers for a satisfactory method of pricing oil inventories.

In the operation of the ideal standard-cost system, the inventory accounts are affected, during a period or as between periods, principally by changes only in the quantities in the inventories and to only a relatively slight extent by adjustments of the standard costs as the result of experience. Under this method, therefore, the fluctuations in actual operating costs receive their full effect in the income account. Another advantage claimed for the standard-cost method is simplicity of operation, which makes it easier to account for the movements of products and the resulting inventory than under the other methods mentioned.

I sincerely hope that the possibility of applying the standard-cost method to the oil industry will be widely studied by the accounting profession and by the industry itself. For, while it may finally be determined that this method is not directly suitable, the theories underlying it may at least provide the basis

upon which a satisfactory method of pricing oil inventories can be evolved.

ARRANGEMENT OF INCOME ACCOUNT TO REFLECT INVENTORY CHANGES

The control which can be exercised by the accounting profession over the problems of the method of accounting for the movements of petroleum products and the basis of pricing is necessarily limited to the continued advocacy and recommendation of principles having the general approval of the profession. On the other hand, the classification of the inventory as between current assets, investments and fixed assets may be made either in the course of the regular accounting procedure or as the result of an audit, and to that extent, therefore, the profession can exercise more direct control over this matter.

Another question relating to oil inventories, which should be under the control of the accounting profession, is the arrangement of the income account so that the various transactions may be suitably reflected there, irrespective of the methods of accounting and pricing employed. The arrangement now generally used in the reports of oil companies is based on the recommendations made several years ago by the American Petroleum Institute's committee on uniform methods of oil accounting, whereby the operating charges were to be segregated as to costs, operating and general expenses; taxes; intangible development costs; depletion and lease amortization; and depreciation, retirements and other amortization. The main features of this recommendation have been quite generally followed, although in particular instances either more or less detail has been shown.

There has, however, been another more recent development, as the result of which the operating charges have been restricted to the costs, operating and general expenses and taxes, after which something called "operating income before reserves" has been shown before the deduction of depletion, depreciation, intangible development costs and amortization. It hardly seems that there could be any argument in favor of this later development which reflects the theories of many writers in financial journals who refer to charges of this nature as "mere bookkeeping entries." Professional accountants quite universally consider that provisions for the exhaustion or extinguishment of fixed assets are just as much a part of costs as salaries and other incurred operating expenses.

Nevertheless, whether the operating costs in the income account are arranged in accordance with the original recommendations of the American Petroleum Institute or in accordance with the later tendency, it is not apparent, from recently published income accounts of oil companies, where the adjustment has been made to reflect the increase or decrease, as the case may be, in the inventory of petroleum products during the year. In all cases where the inventory adjustment is not shown as a separate item it should, theoretically at least, be applied ratably to all the various expenses incidental to the production. It is possible, however, that, in many instances in which the American Petroleum Institute's form of income account is used, the entire amount of the inventory adjustment has been deducted from costs, operating and general expenses to show the total amounts charged off on account of depletion, depreciation, intangible development costs and amortization. While this may be desirable so that the total of these items be shown, it does, in my opinion, result in a misstatement of the costs, operating and general expenses. Where both the inventories at the beginning and at the end of the year and the charges for the extinguishment of fixed assets are relatively small, this misstatement may not be serious, but it could easily run into large sums of money.

Recently I have attempted, in several instances, to correct this condition in audit reports by showing separately, under operating charges, the amount of the fluctuation in the inventory during the period. I should, however, like to go even further than this and group the various items of expenses in such a way as to show exactly, though not necessarily in great detail, those items which, either in whole or in part, are considered applicable to the cost of the product, including therein, of course, as a separate item the amount of the inventory fluctuation. It is quite probable that there may be other and more satisfactory answers to this particular problem, and I should be glad to see an improvement generally adopted, as I do not think that we should continue blindly to follow an arrangement in which an account must be misstated to conform to tradition.

CONCLUSION

In the discussion I have attempted to adhere to general accounting principles to avoid being lost in a maze of detail. Each of the phases discussed has, of course, many ramifications, but it

is probable that once the primary questions are solved the details themselves will fall into place quite easily. It is evident that no one man, no one oil company and no one firm of professional accountants can take the responsibility for deciding these questions or have the authority to influence the general adoption of their opinions. It is, however, possible that the organized bodies of professional accountants can agree among themselves as to the general principles and speed the time when the balance-sheets and income accounts of oil companies, both individually and collectively, shall be more in accordance with the facts than is now possible under several erroneous practices which have unfortunately received the sanction of custom.

Jargon

BY MAURICE E. PELOUBET

Every student of accountancy is ambitious. No one could complete the laborious preparation for professional work without the spur of an overmastering will to succeed. At the same time every young man or woman must indulge in a little day-dreaming. But the accountancy student should regulate his dreams; he should describe his ambition becomingly.

I hope no student will ever vision himself contacting an outstanding figure of the sanitary industry with which he had been associated in a minor capacity in regard to severing his connection with a view to associating himself professionally with a firm of business councillors, thus affording himself a field of endeavor where his ability to personalize facts and figures, to apply the acid test to situations, to overcome executive sales resistance and to evaluate the factors of modern business would have full scope and where he could eliminate the complexes of management and personnel that were inhibiting the progress of the enterprises availing themselves of his services.

Such a day-dream sounds more like a nightmare. The words are English or at least are formed from English words, but the effect is not that of clear and simple English. How much better it would have been if the ambitious youngster's reverie had taken the form of imagining himself telling the president of the plumbing supply dealers for whom he worked as a clerk that he wished to leave them to join an industrial engineering firm where he could use his ability to present facts and figures graphically, to analyze situations and to influence executives and where he could show the management and staff that their fears of change in accepted methods were groundless.

We all think in words and anyone who thinks in the words of the first day-dream is thinking loosely, in words which are borrowed, misused, malformed and indefinite. No one can have clear and definite ideas which he wishes to express plainly, forcibly and unpretentiously and still prefer the gaudy diction of the third-rate advertising man, the clap-trap technical terms of a half-understood psychology or the flat and spurious elegance attained by using a long and indefinite word in place of a short and clear one.

There are several reasons why accountancy students need a warning against the temptation to write and, less frequently, to speak in the repulsive and almost meaningless jargon of the pseudo-economist, the sham psychologist, the quasi-engineer, the "merchandising expert" or the "personnel specialist." These and hosts of other pretenders have but one claim to attention (and money): the ability to convince the unthinking or half-educated that the idea or proposal put forward by the impostor, because it is clothed in long and unfamiliar words, must necessarily be novel and important, while in fact it is old and either already in use or of little merit.

The first reason they should be warned is that, while few writers of accounting texts wish to do other than express plain facts plainly or to state sound opinions temperately, the authors have nevertheless read so many "business" books that they have become unconsciously infected with the flatulence of the authors of works on salesmanship, popular psychology, simplified finance and kindred subjects or, worse, they have recognized their own literary deficiencies and have attempted to form their style on these models.

The accountancy student is required to read a number of books where the content of facts and ideas is of value but where the style and form should be recognized as something thoroughly bad and to be rigorously avoided. The student should consider every technical book to be under suspicion as far as style and language are concerned as soon as some of the tell-tale signs appear, the "in connection with's," "in regard to's," "acid-tests," "factors," "zones" or various kinds of "consciousness." He should then take a few paragraphs at random and try to restate them as fully as they appear in the book but in simpler and fewer words. If he can do this the style and form of the book is worth less than nothing, no matter how valuable the facts or conclusions may be.

The second reason for a warning is the tendency of most professional people to be diffident and over-modest about their gifts of verbal expression, oral or written. This diffidence leads either to flatness and triteness—a misdirected effort at simplicity—or to a shoddy and labored elegance. Most people can talk well when they know what they are talking about and when they are really interested in making a point clear or clinching an argument. Don't be afraid to write as you speak. Don't try to write better than you speak: it will be sure to be worse.

But why all this harping on style, language, elegance, simplicity? Are you going to be newspaper men or novelists? No, certainly not, but many of you who will read these notes hope to be accountants, who will have the accounts of important industries, governments, estates or persons under your care or subject to your review or criticism.

This is a heavy responsibility and in its discharge two things are required: the facts must be proved and assimilated by the accountant and they must then be communicated to stockholders, governmental bodies, directors, officers or to whomever else the accountant is to account. This is the third reason to guard against jargon and flatulence.

Verification and assimilation take more time and require more mathematical and clerical work, but they are not more important than presentation. The results of the most complete and careful audit and accounting work are largely lost if they are not expressed so that the facts discovered or the conclusions reached by the accountant can be understood by those to whom he is reporting. The accountant gets at his facts with figures, but he expresses his results largely in words.

This being so, let them be English words—short, clear and definite, arranged as they are spoken. Use plain words for plain facts. Use exact words for complicated facts. The long and unfamiliar word has its place, but the coined word, the noun tortured into a verb, the borrowed technicality, the jargon chemical term, the misapplied legal phrase or the swelling advertising cliché have no place in a professional man's speech or writing. If he must constantly read and hear jargon let him seek a sure and pleasant antidote, ready to his hand.

This antidote is, of course, well written English verse and prose. Verse is put first because in all good poetry—and this includes much that is not great—simple, familiar words are used to give strength and depth to the most profound, fantastic, humorous or pathetic ideas. The poets whose imaginative power is greatest, whose technical mastery of their art is most complete—Shelley, Poe, Coleridge, Keats or Thompson—whose thought is most profound,—Donne, Herbert or Milton—produce their effect on the reader with simple and familiar words. Their imagination, their power, the whole new worlds they create, are shown to us by means of words we all know, but they are so used as to bring out their full value in meaning, implication, association and sound.

We can not all use words in this way, but the nearer we approach it the better we write and the more good poetry we read the better able are we to use words in exactly the places where they will do the most good.

As for prose, there is much for an accountant to learn from the 18th century when precision and correctness were popular. Jonathan Swift is always clear and forceful, Sterne is lucid and witty, Smollett tells a fine tale. There is no great value in a list of personal preferences, as we should all know which books are good and lasting and which are journalism or jargon bound in stiff boards.

So far as reading goes the accountancy student can not "stay persistently in the presence of the best," for he must study numbers of badly or carelessly written books. What he can and should do is, first, when he reads jargon or something like it to recognize it; second, to resolve mightily never to write that way himself, and third to read as much good poetry and prose as his many and demanding duties will allow. Thus he may escape the pretence and vagueness of jargon and be able, when the day comes, to express the results of his professional work in clear and forceful English.

Money and Bank Deposits

BY HARVEY S. CHASE

What is MONEY? The *Standard Dictionary* says: "Anything that serves as a common medium of exchange in trade, as coin or notes." The *Modern Encyclopædia* says: "Money consists of legally fixed units of a medium of exchange. A 'medium of exchange' is any commodity in terms of which the values of other commodities are expressed." The definition of money accepted by the majority of economists, money theorists and many bankers includes not only currency (coins and notes) but also "bank-deposits." Prof. G. D. H. Cole of Oxford in his book, *What Everybody Wants to Know about Money* (Knopf, 1933), after treating of coin and bank notes and concluding that both are money, then deals with cheques. He says: "A cheque differs radically from a bank note, though they are both in form promises to pay. A bank note is a banker's promise to pay; and if it is issued by a reputable bank it passes easily from hand to hand without necessarily being ever converted into any other kind of money." He then queries: "If we reject cheques from our definition of money, what are we to regard as the money which these cheques transfer from one person to another? This brings us to the question of bank deposits. Bank deposits are, in the most developed communities, by far the most important means of payment and those with the aid of which the largest and most important business transactions are habitually settled. It seems then that our definition of money must be wide enough to include bank deposits."

This conclusion is also accepted by Professor R. F. Harrod of Oxford, author of *International Economics*, who says: "The total amount of money in the community is found by adding together the amounts held by all individuals, corporations and institutions; it is equal to the total of coins and notes in circulation plus all the deposit balances at all the banks."

Similar quotations from students of finance, with hundreds of assertions that bank deposits are "money" might be quoted from well-known professional experts in America as well as Great Britain.

Dr. Ralph A. Young of the Wharton school of finance, in a volume published by the national industrial conference board

under the title *The New Monetary System of the United States* (August, 1934), says: "Treasury currency constitutes only a part of our domestic supply. Actually, it constitutes only a small fraction of the total effective monetary supply in the hands of the public for spending. The bulk of the effective supply is furnished by the commercial banks in the form of deposits subject to cheque." One more quotation may seem to clinch the argument. Hon. Reginald McKenna, chairman of the Midland Bank, Ltd., of London, is quoted as saying, "By far the larger part of our total money consists of bank deposits."

It would seem the height of temerity, in the face of such wide acceptance of "deposits" as money, even to suggest that there may be another answer—a negative one. Nevertheless, examining the matter from the point of view of a professional accountant familiar with banking methods and aware of the necessities of bank practices, I have become convinced after much study of both sides of this question that the statement "banks create money" is erroneous. Such a statement follows from the generally accepted first premise that "banks create credit" by allowing customers to have chequing accounts through "bank deposits." The second premise, "bank-deposits are money," leads logically to the conclusion, "banks create money."

It is advisable, I believe, to reconsider the question from the standpoint of reality: from the basic facts of bank practices and necessities. Those who accept the affirmative, "Bank-deposits are money" generally picture the banker, when granting a loan to a customer, as immediately setting up a credit to the customer on the bank's books, against which the customer may draw cheques and pay his creditors and employees with these cheques. In due time these cheques return to the bank which charges them against the deposit account set up "by a stroke of the banker's pen." Certain extremists, such as the proponents of social-credit and allied hypotheses, assert that these procedures prove that the banker created money when the credit-deposit was set up and that this was actually "creation" because "it arose from nothing."

To analyze this contention, consider what actually occurs when bankers make loans and set up "deposit-accounts" to the credit of their customers. Bank "A," we will say, after sufficient inquiry, accepts a customer's application for a loan of ten thousand dollars, due in three months. The bank takes the customer's

promissory note for that sum and enters on the bank's books a debit account for the note as an asset. In other words, the bank has bought the customer's note and must now pay for it. Consider two ways of paying for this purchase. First, suppose the customer desires cash for the full amount, less the discount. The bank (A) pays over the counter ten thousand dollars in currency, minus the interest for three months. Evidently in such a transaction no "deposit account" is set up. The bank has merely swapped one type of asset, cash, for another type of asset, promissory note. It has bought and paid for an earning asset.

Suppose, secondly, that after paying over the currency to the customer (X) the latter decides that it will suit his convenience to return this money to the bank and have it credited to a deposit account in his name on the books, against which he may draw cheques as he pleases. Evidently, in this second case, there is no "creation" of money when the banker's stroke of the pen sets up the deposit account for the customer. The bank paid out ten thousand dollars (omitting discount for simplicity) and gets the ten thousand back again. The banker's pen was busy but it did not create money.

Consider a third method, the usual one, namely: The bank takes the note as before and sets up the asset account for the note. The banker, however, does not pay the customer for the note then and there, but instead he sets up a deposit account for ten thousand dollars on his books as a credit to the customer. What does this action imply? The banker has bought the customer's note but he does not pay for it. Instead he gives a credit to the customer for the amount of the note. Evidently this credit account is a liability, a record of the bank's debt to the customer for the note it has purchased from him.

This, then, is what the "deposit account" means—a *debt* of the bank. How does the bank propose to pay this debt? It proposes to pay by honoring the customer's (X's) cheques, which the customer draws as he desires, up to the full amount of the debt. As each cheque reaches bank A, over the counter or from other banks, the amount is charged against the credit account of the customer and thereby reduces the bank's debt to the customer. Each cheque is cancelled by the bank and returned to the customer as evidence that the bank has received and charged it, leaving the balance of the debt still unpaid. Finally a last cheque wipes out this balance and the bank has then paid its debt in full.

The bank now owns the note free and clear and can collect the ten thousand at maturity.

The picture is not complete if we stop here, however, as social-credit and other propagandists do. There are extremely important actions which occur when each cheque reaches bank A. If some of these cheques are presented by employees of X who desire to cash them, the bank will pay the cheques in currency over the counter and its cash assets will be correspondingly reduced. This is clear. The bank has paid for these cheques, not in "thin air" or "creation from nothing," but in hard coin or legal tender bank notes, definitely diminishing its accumulated assets.

The majority of the customer's cheques, however, will reach bank A from other banks, B, C, D, etc., where X's creditors have deposited the cheques they received from him in payment of his debts to them. The banks (B, C, etc.) enter these cheques to their customers' credits and stand ready to pay for them over the counter in currency if called for. Through "clearing," all these cheques ultimately reach A and are paid by A through transfer of cash, or diminishment of credits, to B, C, etc. These settlements through clearing are just as real payments of the cheques, by A's actual assets, as if paid in cash over the counter. My readers must see that this is true. All the cheques drawn by X have to be paid for in good assets by bank A. There is no escape. Evidently the stroke of the banker's pen which set up the deposit-account to X in the beginning did not "create money." It created the record of a debt, due to X by the bank because of the bank's purchase of X's note.

It is plain to see that, so far as the giving of credit is concerned, the bank created no credit for X. On the contrary X allowed credit to the bank. Literally, he did so. He permitted the bank to take his note and add it to the bank's assets without giving him anything except a promise to pay for his cheques as drawn. The bank got X's note for ten thousand—a good asset—"for nothing" temporarily, but had to pay for it, cheque by cheque, in correspondingly good assets as these demands came in. The whole transaction is in accord with the first illustration given, where the bank surrendered ten thousand dollars of cash assets and received a like sum through X's note at three months. There was no "creation of money" in the first case, as is plainly evident. No more is there creation of money in this last case.

Assets have been exchanged for assets in both cases. No new money appeared in either case. The only difference is that in the first case the bank paid its debt immediately in cash, while in the last case it took its time about paying it or, rather, it took Mr. X's time—as his cheques were honored.

When banks must pay in good assets for every customer's cheque they honor, the allegation of "creation of money from nothing" is absurd, no matter what distinguished men support such an hypothesis. Such assertions are based upon ignorance of the necessities of banking practice or upon the failure to "think through" the actualities of that procedure.

Major Douglas of social credit asserts that banks buy securities for nothing. "Any normal type of bank," Major Douglas says in a recent magazine article, "acquires securities by exchanging a draft upon its own credit for the securities, thus increasing the money in the hands of the public by the amount paid and increasing its own assets by the securities acquired." He goes on, "It is quite fair to say that a financial institution in such a case acquires securities for nothing."

Securities, like promissory notes, are records of debts. Securities are generally long-time debts while notes are usually short-time debts. When banks (federal reserve banks, for instance) purchase securities in the open market they may not pay for them immediately over the counter but set up liability accounts on their books to the credit of the person, firm or corporation from whom they purchased the security. This "credit"—like that arising from the purchase of a customer's note—is not creation of money but is merely a record of debt to the seller or to the government if bonds or short-time paper are purchased directly from the government. Hundreds of millions of dollars of such securities are purchased by banks, carrying with them book records of increased assets (values of the securities) and correspondingly increased liabilities—the deposit accounts—in these banks.

There should be no distinction in theory or practice between open-market operations and promissory-note operations—merely differences in the kinds of promises to pay. The effects on bank deposits are identical; there is no creation of money in either case and the allegations by proponents of fantastic hypotheses are as untrue in one case as in the other.

Bank deposits are being built up in enormous quantities today through purchase by banks of our government's securities—

long and short terms—and corresponding vast issues of cheques are flooding the mails and clearing associations. These tangible cheques act temporarily as media of exchange. They pass from bank to bank and sometimes from hand to hand like currency, but Professor Cole says they are not money and in the same breath he says the intangible book records of bank debts—“deposit accounts”—are money. If cheques have not all the qualities of bank notes and other “currency,” they certainly have more of these qualities than have the mere book records of banks’ debts. They at least are tangible like currency; they are “media of exchange” certainly; they pass from one to another person or bank and they are promises to pay, as bank notes or government currencies are.

“Bank deposits,” on the contrary, have none of these qualities of money. They are intangible; they do not pass from hand to hand; they are merely book records representing the increases and decreases of banks’ debts. If cheques can not be considered “money,” as Professor Cole declares, then certainly there is no logic in claiming bank deposits to be money.

It is clear from these considerations that any statement to the effect that banks “create money” by writing up “deposits” is untrue. The process is not one of creation but is one of exchange. It is subject to definite limits and the deposits which appear are only potential money claims. Indeed, they become actual increases of purchasing power only when the initiative in the growth of assets (notes), and of deposits correspondingly, comes not from the banks but from customers who desire to make immediate use of the convenience and safety of chequing-accounts at the banks.

The only valid excuse for considering the total of bank deposits to be money, as is so habitually but illogically done by many of our leading economists and statisticians, arises from the fact that as there is no possible means of determining what values of cheques (drawn against deposit accounts) are afloat in the mails at any moment relating to any bank, the only figures which it is possible to use are the total cheques “cleared” during the day, with the total of all balances of deposit accounts at the end of the business day.

While such figures give only approximate indications of the total cheques which all the John Joneses and the Bill Smiths have drawn that day—which constitute the real media of exchange—

yet the total of unpaid balances of deposits compared one day with another does give some indication of the so-called "bank money" afloat, and from such comparisons reasonably fair estimates may be made on which to base decisions as to whether business as a whole is increasing or decreasing. Thus it has come to be assumed that bank-deposit balances represent purchasing power and may be considered "credit money" or "contingent money" or "bank currency" or, finally, plain money.

Perhaps the simplest way to clarify these rather complicated questions to the average intelligent but uninformed person is to compare "bank deposits" with everyday claims for wages and salaries for work done, services rendered. The reader, whatever his vocation, works for an expected—usually an agreed upon—compensation. All through the week or month he works daily at his particular stunt. He accumulates a wage-claim against his employer. This wage-claim is a debt of his employer to him. It is not money. The money in the case is in his employer's pockets or bank account and all the worker has is a claim against this money. In due time his wages are paid in currency (or by cheque, good for currency) and he has the money. The claim, while it was a debt the employer owed him, was not money.

Just so, the bank-deposit is not money. It is a claim, like the wages earned, against the money (liquid assets) of the bank. The bank pays the claim by accepting the customer's cheques and paying for them in currency or credit to other banks or cash over the counter.

The conditions are identical. The wage-claim is not money; no one will assert that it is money by itself, but our economists and illogical bankers say the claim of the deposit account is money. The error is evident. The money is in the bank's vaults and reserves—liquid assets. The claims against it, represented by deposit-account balances, are not "purchasing power." The assets are the only purchasing power, both in the case of the wages-claims and of the deposits-claims.

One of the most voluminous writers of the day in a recent magazine article made this statement: "If a person has a million dollars and loans it, he does not have the million dollars any more, tho' he has the borrower's note, but if a bank has a million dollars and loans it, the bank has two million dollars—the million it had at first and the million created by the 'deposit' set up by the

loan." Two millions for one. Grand! Let's all go into the banking business.

Absurd as this statement appears in cold type, it is typical of the misunderstandings prevalent in all quarters which depend upon alleged expert economists' assertions, such as "bank deposits are money."

The writer in question was misled by a lack of visualization of accounting requirements. He thought of the million assets of the bank as one item and of the "created" deposit from the loan as a second item, failing to realize that while the first is a reality, a plus item, the second is a debt, a minus item. If added together they cancel each other and there is nothing left—not "two millions" for one. What remains on the bank's books is only the value of the note or security, an asset of one million dollars—the cash and the deposit are both wiped out. This is what occurs in fact, though not immediately in practice. The bank's cash assets are reduced by every customer's cheque honored and the customer's deposit-account is similarly reduced by each of such cheques until finally both accounts disappear simultaneously.

CONCLUSIONS

1. Bank deposits are not credits granted to customers by banks, but are records of the debts of the banks to their customers.

2. Bank deposits are intangible and in themselves have none of the characteristics of money except the claim that they are, as Professor Cole puts it, "by far the most important means of payment."

3. What are the tangible "means of payment" identified with bank deposits?—Cheques, evidently.

4. What gives cheques their power as "means of payment"? Is it because they are drawn against a bank deposit, as such—a debt record of the bank? Or is it because the drawer of the cheque has assumed thereby, with the sanction of the bank, a status of creditor to the bank; in command of the bank's liquid assets up to an agreed limit?

5. It is this right to call for liquid assets of the bank to be paid over to his own creditors that gives the "means of payment" power to cheques. Bank deposits, when liquid assets of the bank are gone, have no power of payment. They stand on the books as they did before the run or the scandal which wiped out the assets, but they are valueless. The bank's liquid assets are

the true "means of payment," not the records of debts—the bank deposits.

6. It is because this fundamental fact is not recognized or is glossed over by writers on banking theory that amateurs like Major Douglas, Frederick Soddy, Guy Mallon and countless others have misunderstood the actual relationships and have laid emphasis in the wrong place, by declaring that the writing of a bank deposit "creates money." The fact is that the money is already in the bank's assets and the "deposit" is merely the bank's acknowledgment that the customer has the right to use these liquid assets for his own purposes by means of his drafts (cheques) against the bank.

7. It is for this reason—the right to use the bank's assets as his own—that the customer is willing to pay interest upon his note, sold to the bank but not yet paid for. The great advantage to the customer of using the bank's funds and its financial standing for his own purposes, up to the limit set by the note, fully justifies the payment of interest as a service charge for these advantages. The bank gives quid pro quo—not "something from nothing."

Of course the service charge (the interest) may be too high for the service rendered. The customer must decide that—if free to do so. If not free to do so, the excess may be theoretically considered usury, and something for nothing begins to appear.

8. These conclusions, which arose from a critical study of "social-credit" early in 1935, are primarily intended to make evident the erroneous nature of the assertions of Major C. H. Douglas and his supporters. Misled by the plausible and, doubtless, sincere beliefs of the proponents, many thousands of untrained individuals in England, Australia, New Zealand, Canada and the United States are giving wider credence daily to these mistaken ideas—such as I have quoted. It is necessary, therefore, in the interest of truth and of correct understanding of banking theory and practice, that these erroneous ideas be combatted.

9. It is, of course, true that bank-deposits when viewed from the reversed position of the borrower rather than from that of the banker, i.e. as *assets* in the private books of the borrower instead of as liabilities on the books of the bank, may with some measure of verity be considered prospective "means of payment," as claims against the actual assets of the bank. For the borrower, who must pay his debts to his creditors, the ability to draw upon the bank's assets by means of the cheque system of the bank, justi-

fies him generally in considering his deposit balance at the bank as his best "means of payment." With sound banks and in normal times he may believe his bank account to be, perhaps, his most assured asset, but in abnormal times, such as the world has been experiencing, this dependence upon his bank balance as a secure and most convenient asset is upset; his assurance that this account as *money* is lost and he demands bank-notes, government currency, or gold in place of such "contingent money." When the emergency arrives, his belief in the money value of bank deposits fades away and the uncertain nature of "deposits" as *money* becomes vividly apparent.

10. The crux of these opposing assertions regarding what should be included in the term "money" is this: (1) The economic definition of money is; A commodity which is generally accepted by business men of all classes and nations as "a common medium of exchange." This is the original and primary meaning of "money." (2) The juristic definition of money is; A generally accepted "means of payment." This definition of money is the one which has been adopted, consciously or unconsciously, by those who assert that bank-deposits, bank-notes, cheques and other "money-substitutes" should be included in the term money. From a juristic point of view money is primarily "a means of payment," but only because money is accepted as a common medium of exchange. The juristic view is secondary; the economic view is primary.

Professor Ludwig von Mises, of the university of Vienna, the leading and most profound economist on the continent of Europe, says in regard to the juristic view: "The concept of money as a creature of law and the state is clearly untenable. It is not justified by a single phenomenon of the market. To ascribe to the state the power of dictating the laws of exchange is to ignore the fundamental principles of money-using society. From the legal point of view money is the common medium of payment or debt-settlement, but money becomes a medium of payment only by virtue of being the medium of exchange. Only because of this does the law make it the medium for fulfilling obligations not contracted in terms of money, but whose literal fulfillment is for some reason impossible. . . . It does not come within the scope of the legislator or jurist to define the economic concept of money."

So the confusion and contention simmer down to a logical choice between definitions 1 and 2. The first has come down from remote antiquity and is primary in economic science. The

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second is a relatively recent adoption by modern schools of economists and bankers, who advocate the idea of money as a "thing of thought" only, which acts by judicial interpretation as a "means of payment" and therefore that all accepted means of payment must be money.

To bewildered students I advise an intensive study of von Mises' recently translated book (English) *The Theory of Money and Credit*.

The Partnership Return of Income

FEDERAL FORM—1065

BY CHARLES M. EDWARDS

The procedure in preparing partnership returns has been considerably simplified in the 1934 law in comparison with previous years, yet there remain a few points which are still open to controversy as to their exact meaning, and being controversial are often confusing. Confusion should be avoided in both the regulations and the forms.

The first of these points open to several interpretations is section 181 of regulation 86. It is "that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year." It is clear that the government wants each partner to pick up his share of the net income of the partnership. It is also clear that the total net income to be picked up includes only reportable income and allowable deductions. But what is meant by "distributive share"?

A constant pro-rata profit-and-loss distribution introduces no difficulties in computing the percentage of net income reportable by each partner, but an agreement which varies the partners' distributive percentages as net income varies may create some difficulties. In determining the distributive share, we first find the net income and apply the partnership profit-and-loss agreement and determine what percentage of the net income each partner would receive.

There are three alternative methods of determining the net income used in computing the partner's distributive percentages: (1) the net income per books, (2) the net income as shown on item 24 of form 1065, (3) the net income on item 24 plus the partnership's income from liberty bonds.

It might be assumed that the treasury department might recognize only one net income, that found on the return; yet there is no reference to which basis to use and it is apparently left to the taxpayer to determine. The determination is often quite important. The second method, the net income per form 1065, may force one partner to assume a larger percentage of the taxable income than he has actually received. Or if the distributive share

The Partnership Return of Income

has been found as in method one, using book profit as a basis, one partner may have to assume all the difference between book profit and taxable income. To explain this assume the following illustration:

The A & B partnership has a profit-sharing agreement as follows: "1st, A shall receive a salary of \$12,000, 2nd, each shall receive 5% on his investment, 3rd, the remaining profit shall be distributed equally." A's capital account is \$50,000 and B's is \$100,000. For the taxable year the operating income is \$200,000; operating expenses \$148,000; there is a capital loss of \$40,000. It can readily be seen that the net income per books is only \$12,000.

Determination of net income

	1	2	
	Per books		Taxable income per partnership return
Gross sales	\$200,000		\$200,000
Less expenses	140,000		148,000
	\$ 52,000		\$ 52,000
Operating profit	\$ 52,000		\$ 52,000
Less capital loss	40,000 (Limit)		2,000
	\$ 12,000		\$ 50,000
Net income			

Naturally, if the 1st method is used A would receive the \$12,000, as salary, and B would receive nothing. A, under this method, would pick up 100 per cent. of the taxable income, or the entire \$50,000.

Under the second method, applying the profit-and-loss agreement to the taxable income, the distribution would be as follows:

Partners	A	B	Total
Salary	\$12,000		\$12,000
Interest on investment	2,500	\$5,000	7,500
Remainder equally	15,250	15,250	
	\$29,750	20,250	\$50,000
Taxable share	\$29,750	20,250	\$50,000
Distributive %	59.5%	40.5%	100%
	59.5%	40.5%	100%

It might seem that for A to receive 100 per cent. of the actual book profit (\$12,000) and yet be taxed for only 59.5 per cent. of the net income would be an injustice to B. This would result if method 2 were used. However, it is certainly more equitable to

distribute the unallowable capital loss between both A & B, as is done in method 2, than to make A assume it all.

Method 3, except in rare cases, would differ little from method 2, and the fact that it will not be known how much of the liberty bond interest each partner will have to pick up on his individual return until he has completed that return makes it appear to be little improvement on method 2. It would cause more bother and would not result in any particular advantage.

Any one specific method is apt to result in injustices from the viewpoint of some one of the partners who would be forced to pick up more taxable income than would be required by some other method. However, in view of the multitude of situations that might exist, method 2 seems the most equitable of any one solution.

My second criticism concerns the earned income credit. The regulations state that a partner may claim as earned income a reasonable amount for his personal services up to 20 per cent. of his share of the net income of the partnership. Assuming that "his share" has been definitely settled, what amount will be used as net income? (1) Is it the figure shown on item 5 on the individual return, entitled "income from partnership," yet excluding both dividends and liberty bond interest? (2) Is it the partners' share of item 24 on the partnership return which includes dividends but not liberty bond interest? In view of the present forms the latter would seem to be the more logical, as earned income is computed on the partnership return, before the amount of liberty bond interest which the partners will pick up is known. (3) Or does net income mean all reportable income on the individual return, including the amount of partnership profit in item 5, dividends in item 10a, and the liberty bond interest to the amount that is reportable in item 9?

In the vast majority of cases this difference would have little effect on the amount of tax payable and the selection of 20 per cent. of any item is a purely arbitrary basis that could be changed, but for the sole sake of simplification this regulation should be clarified.

The third item is that there is no clear connection between the individual return and the partnership return. The purpose of the partnership return, form 1065, is to facilitate and check the return by the partner as an individual taxpayer, yet no provision has been made on form 1065 to show the definite amount which

The Partnership Return of Income

each partner should place in item 5 on the individual return. While it is true that by a small exercise of arithmetic this can be determined by one who knows what is wanted, for one who doesn't, it causes needless trouble.

To illustrate this weakness in the form, a comparison may be made of the present form and one that might be an improvement.

Partners or members' shares of income and credits

Column	Present form	Column	Suggested form
1.	Name and address of partner	1.	Name and address of partner
2.	Percentage of net income	2.	Percentage of net income
3.	Dividend (item 10 (a) above)	3.	% times item 24 (above)
4.	Earned income	4.	% times dividends (item 10 (a) above)
5.	Balance of net income (item 24 minus sum of amounts in columns 3 and 4)	5.	Balance of net income (item 3 minus item 4)
6.	Income tax paid at the source (2% of item 6)	6.	% times liberty bonds and treasury bonds owned
7.	Income tax paid foreign countries or United States possessions	7.	Earned income
		8.	Income tax paid at the source (2% of item 6)
		9.	Income tax paid foreign countries

Item 5 on the present form means nothing in itself. Item 5 on the suggested form would show the actual amount the partner would pick up in item 5 on the individual return. Item 4 will go into 10a, as No. 3 now does; item 6 will go in schedule D on the individual return. Items 7, 8 and 9 correspond to items 4, 6 and 7, respectively, on the present form.

I do not claim that the suggestions, concerning (1) definite instruction relative to the determination of "partners' shares," (2) a definition of the basis for finding the "earned income credit" and (3) a revision in the partnership form, are the best suggestions that can be made to clarify partnership procedure, but I do believe that they would simplify the return considerably.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department*.]

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 14, 1935, 1:30 P. M. to 6:30 P. M.

Solve problem 1 or 2, problems 3, 4 and 5 and problem 6 or 7.

No. 1 (30 points):

A public service corporation about to issue \$53,000,000 first mortgage bonds, to be dated July 1, 1935, and due July 1, 1965, sought bids from underwriters which narrowed down to two:

- (1) "A" offers for itself and others for $3\frac{1}{2}\%$ coupon bonds 101.913 per cent. of par, the company to receive \$54,013,890.
- (2) "B" offers for itself and others for 3.4 per cent. coupon bonds 100.417 per cent. of par, the company to receive \$53,221,010.

The legal and accounting expense of the company applying to the issue is \$300,000. Interest is payable semi-annually on January 1st and July 1st.

The company has outstanding an issue of non-callable, three-year 5% coupon notes dated April 15, 1933, due April 15, 1936, amounting to \$16,000,000, interest on which is payable semi-annually. The current market price of these notes is 103 and interest.

After awarding the issue to A for offer (1), the president of the company issued the following announcement:

"The management has recommended and the directors have approved the sale of \$53,000,000 par value, first mortgage $3\frac{1}{2}\%$ bonds to "A" which bid 101.913 per cent. to the company. . . .

"The management and directors gave long and serious consideration to offer (2) of "B," carrying a 3.4 per cent. coupon. Although this would mean an interest saving of \$53,000 a year over the 30-year life of the bonds the premium offered amounted only to \$221,010 as compared with a premium of \$1,013,890 in offer (1) of A. The receipt of nearly \$800,000 in additional money at this time would be a great advantage to the company in further reducing the short-term debt still outstanding after the completion of this issue. The management is strongly of the opinion that this advantage more than offsets the interest saving under the lower coupon rate."

Assuming you had been asked to help the directors in awarding the bid, what reasoned opinion would you have given?

NOTE.—The calculations in this problem may be made either by arithmetic or by actuarial methods.

On the basis of $3\frac{1}{2}\%$ interest per annum, payable semi-annually:

Present value of \$1 payable after 60 half yearly periods. . . .	\$.35313
" " "\$1 per annum over 60" " " 	\$36.96399

Solution:

The effective rates of interest may be approximated by the use of the following formulae in which:

r = the effective rate per period of six months

I = the total interest payable over the entire life of the bond

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P = the par value of the bond (\$1,000)

S = the selling price of the bond (the amount received after expenses, by the issuing company)

Pr = the premium

D = the discount

n = the number of interest periods or payments

If the bonds are sold at a premium:

$$r = \frac{2(I - Pr)}{n \left(S + P + \frac{Pr}{n} \right)}$$

If the bonds are sold at a discount:

$$r = \frac{2(I + D)}{n \left(S + P - \frac{D}{n} \right)}$$

While both the offers provide for a premium to be paid to the issuing company, the legal and accounting expenses must be considered as a reduction of such premium in computing the interest cost. Hence, in the following schedule of factors in terms of a bond of \$1,000 the \$300,000 expense for services is deducted from the sales price and the premium in the case of "A". In the case of "B", whose offer provides for a premium of \$221,010, the service charge converts the premium into a discount of (\$300,000 - \$221,010) \$78,990 for the purpose of our calculation.

	Amount	Per \$1,000 bond
"A's" offer:		
Sales price (\$54,013,890 - \$300,000).....	\$53,713,890.00	\$1,013.47
Premium (\$1,015,890 - \$300,000).....	713,890.00	13.47
Interest payable during the entire life of the bonds (3½% of \$1,000 for 30 years).....		1,050.00
"B's" offer:		
Sales price (\$53,221,010 - \$300,000).....	52,921,010.00	998.51
Discount (\$300,000 - \$221,010).....	78,990.00	1.49
Interest payable during the entire life of the bonds (3.4% of \$1,000 for 30 years)		1,020.00

Solving for "A":

$$\frac{2 (\$1,050.00 - \$13.47)}{60 \left\{ \$1,013.47 + \$1,000.00 + \frac{\$13.47}{60} \right\}} = \frac{\$ 2,073.06}{\$120,821.40} \text{ or } 1.716\% \text{ per period.}$$

Solving for "B":

$$\frac{2 (\$1,020.00 + \$1.49)}{60 \left\{ \$998.51 + \$1,000.00 - \frac{\$1.49}{60} \right\}} = \frac{\$ 2,042.98}{\$119,909.40} \text{ or } 1.704\% \text{ per period.}$$

Or a semi-annual interest saving of approximately 1.20%

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On an issue of \$53,000,000 of bonds, the semi-annual interest saving would amount to $(\$53,000,000 \times .012\%)$ \$6,360.

This semi-annual interest saving, expressed in terms of its present value at a rate of $3\frac{1}{2}$ per cent. amounts to $(\$6,360 \times 36.96399)$ \$235,090.98. However, the use of a rate of $3\frac{1}{2}$ per cent. is subject to question because of the many other factors involved. If any interest saving is to be discussed, it would be preferable to state the semi-annual saving of \$6,360.

The next question to consider is the president's statement that the advantage of a reduction in the company's short term debt of approximately \$800,000 more than offsets the interest saving under the lower coupon rate. If the current market price of the 5 per cent. notes outstanding reflects the current rate for short term money, we find that the rate is 1.2 per cent. per annum as shown below:

Interest at 5% from July 1, 1935, to April 15, 1936	\$39.46
Premium	30.00
	9.46
Net interest for 288 days	9.46
	1.2%
Annual rate $(9.46 \times 365/288)$	

The assumption that approximately 762 of these \$1,000 notes could be acquired immediately on the open market without causing an increase in the market price, is subject to question. Even though it were possible, paying .024 per cent. more for the long term bond interest would not be offset by the purchase of the \$762,000 of short term notes paying 1.2 per cent. per annum.

Another point to consider is the possibility of reacquiring some or all of the issue of bonds before maturity, at a favorable price. In any given market bonds bearing a coupon of 3.4 per cent. could be acquired for a smaller premium than the same bonds bearing 3.5 per cent. coupons. Such savings, although impossible of accurate estimation, would nevertheless be real and undoubtedly considerable.

No. 2 (30 points):

The following statement gives the account balances on the books of a college at the end of the fiscal year before closing:

	Debit	Credit
General current funds		
Cash	\$ 17,000	
Investments	20,000	
Accounts receivable	3,000	
Inventories	18,000	
Estimated income	1,385,000	
Appropriations		\$1,360,000
Accounts payable		2,000
Reserve for working capital		20,000
Unappropriated surplus (after entering budget)		111,000
Educational and general expenditures	1,060,000	
Auxiliary enterprises expenditures	252,000	
Other non-educational expenditures	26,000	
Educational and general income		1,070,000
Auxiliary enterprises income		315,000
Other non-educational income		15,000
Transfer to endowment	50,000	
Transfer to plant funds	62,000	
	\$2,893,000	\$2,893,000

Students' Department

	Debit	Credit
Restricted current funds		
Cash	\$ 3,000	
Investments	58,000	
Accounts payable		\$ 1,000
Fund balances		60,000
	<u>\$ 61,000</u>	<u>\$ 61,000</u>
Loan funds		
Cash	\$ 1,000	
Investments	5,000	
Notes receivable	36,000	
Income		\$ 2,000
Funds principal beginning of year		25,000
Gifts to loan funds during year		15,000
	<u>\$ 42,000</u>	<u>\$ 42,000</u>
Endowment and other non-expendable funds		
Cash	\$ 3,000	
Securities	857,000	
Funds in trust	100,000	
Profit on sales of investments		\$ 10,000
Endowment funds principal beginning of year		700,000
Gifts to endowment		100,000
State tax collections for endowment		100,000
Transfer from current funds (temporary)		50,000
	<u>\$ 960,000</u>	<u>\$ 960,000</u>
Funds subject to annuities		
Cash	\$ 1,000	
Investments	99,000	
Fund balances, beginning of year		\$ 80,000
Gifts of annuity funds		20,000
	<u>\$ 100,000</u>	<u>\$ 100,000</u>
Unexpended plant funds		
Cash	\$ 4,000	
Investments	15,000	
Expenditures for plant additions	360,000	
Replacement funds balances		\$ 15,000
Plant additions funds balances, beginning of year		50,000
State appropriation for plant additions		200,000
Gifts for plant additions		50,000
Income on investments		2,000
Transfer from current funds		62,000
	<u>\$ 379,000</u>	<u>\$ 379,000</u>
Funds invested in plant		
Educational plant, beginning of year	\$3,100,000	
Bonds payable		\$ 100,000
Investment in plant		3,000,000
	<u>\$3,100,000</u>	<u>\$3,100,000</u>
Agency funds		
Cash	\$ 2,000	
Investments	8,000	
Fund balances		\$ 10,000
	<u>\$ 10,000</u>	<u>\$ 10,000</u>

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Attention is called to the following facts and conditions which are disclosed upon examination of the records:

- (1) Notes of loan fund amounting to \$500 are found to be uncollectible and are to be written off.
- (2) An annuity fund of \$1,000 for current purposes has matured through the death of the annuitant.
- (3) Included in the educational expenditures of the year from current funds is the sum of \$14,000 for new equipment.
- (4) Equipment included in plant assets at beginning of year to the amount of \$32,000 had worn out or other disposition of it had been made.
- (5) Orders and contracts outstanding at close of year and payable from current funds appropriations amounted to \$6,000.
- (6) An analysis of endowment funds shows that at the beginning of the year \$200,000 included therein represent undesignated funds temporarily functioning as endowment.
- (7) A further analysis indicates that \$100,000 of endowment funds has been expended for a residence hall, the value of which is included in plant assets but not in endowment funds.
- (8) Income and expenditures of restricted current funds are included in the budget estimates and in the totals of income and expenditure carried in the general-funds section.

You are required:

- (a) To make the necessary closing entries in all funds.
- (b) To prepare a balance-sheet after closing.
- (c) To prepare a statement of current income, expenditures and surplus for the year.

Solution:

Adjusting entries

(1)			
Funds principal — loan funds	\$	500	
Notes receivable — loan funds			\$ 500
To write off the notes of loan fund of \$500 which are uncollectible.			
(2)			
Cash — general current funds		1,000	
Fund balances — funds subject to annuities		1,000	
Cash — funds subject to annuities			1,000
Unappropriated surplus — general current funds			1,000
To record the transfer of \$1,000 in cash to the general current funds which cash is available because of the death of the annuitant.			
(3)			
Expenditures for plant additions — funds invested in plant		14,000	
Plant additions funds balances — funds invested in plant			14,000
To set up the new equipment purchased from current funds.			
(4)			
Investment in plant — funds invested in plant		32,000	
Educational plant — funds invested in plant			32,000

Students' Department

To write off the plant assets of \$32,000 which had worn out or had been otherwise disposed of during the year

(5)

Appropriation expenditures — general current funds.	\$ 6,000	
Orders and contracts payable — general current funds		\$ 6,000
To record the liability on orders and contracts outstanding at the end of the year		

(6)

Endowment funds principal — endowment funds	200,000	
Undesignated funds — endowment funds		200,000
To indicate the undesignated funds included in the endowment funds principal balance at the beginning of the year		

(7)

Undesignated funds — endowment funds	100,000	
Endowment funds principal — endowment funds		100,000
To credit the principal account with the amount expended for the residence hall. It is assumed that while the balance of the undesignated funds at the beginning of the year amounted to \$200,000 that the amount expended for the residence hall was taken from the undesignated funds.		

Closing entries

(8)

Educational and general income	1,070,000	
Auxiliary enterprises income	315,000	
Other non-educational income	15,000	
Estimated income		1,385,000
Unappropriated surplus		15,000
To close the revenue accounts and to transfer the excess of actual over estimated revenues to the unappropriated surplus account.		

(9)

Appropriations	1,360,000	
Unappropriated surplus		
Educational and general expenditures		1,060,000
Auxiliary enterprises expenditures		252,000
Other non-educational expenditures		26,000
Appropriation expenditures		6,000
Unappropriated surplus		16,000
To close the appropriation and expenditure accounts to unappropriated surplus.		

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(10)		
Unappropriated surplus	\$ 62,000	
Transfer to plant funds		\$ 62,000
To write-off the transfer to plant funds		
(11)		
<i>Loan funds:</i>		
Income	2,000	
Gifts to loan funds during the year	15,000	
Funds principal		17,000
To close the income and gifts account to funds principal account		
 Endowment and other non-expendable funds:		
(12)		
Profit on sales of investments	10,000	
Gifts to endowments	100,000	
State tax collections for endowment	100,000	
Endowment funds principal		210,000
To close the income, gifts and tax collection accounts to the funds principal account		
 Funds subject to annuities:		
(13)		
Gifts to annuity funds	20,000	
Fund balances		20,000
To close the gifts account to the fund balances account		
 Unexpended plant funds:		
(14)		
State appropriations for plant additions	200,000	
Gifts for plant additions	50,000	
Income on investments	2,000	
Transfer from current funds	62,000	
Plant additions funds balances	46,000	
Expenditures for plant additions		360,000
To close the state appropriations, gifts, income, expenditure and transfer accounts to the funds balances account		
 Funds invested in plant:		
(15)		
Educational plant	360,000	
Investment in plant		360,000
To record the additions to the plant during the year		

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A College
Statement of surplus (fund balances) accounts for the year ended—blank date

	General current			Endowment	Annuities	Unexpended plant funds	Plant	Agency
	Unrestricted	Restricted	Loan					
Balance beginning of year.....	\$86,000	\$60,000	\$25,000	\$700,000	\$80,000	\$ 50,000	\$3,000,000	\$10,000 (1)
<i>Add:</i>								
Income.....		56,000	2,000			2,000		
Gifts.....			15,000	100,000	20,000	50,000		
State tax collections.....				100,000				
Profit on sale of investments.....				10,000				
State appropriation.....						200,000		
Transfer from general fund.....		62,000*				62,000		
Additions to plant.....							374,000	
Total.....	\$80,000	\$60,000	\$42,000	\$910,000	\$100,000	\$364,000	\$3,374,000	\$10,000
<i>Deduct:</i>								
Uncollectible note receivable.....			500					
Transfer to undesignated funds.....				100,000	1,000	360,000		
Transfer to general current fund.....		1,000*						
Transfer to plant investment.....							32,000	
Assets retired.....								
Balance end of year.....	\$81,000	\$60,000	\$41,500	\$810,000	\$ 99,000	\$ 4,000	\$3,342,000	\$10,000

(1) NOTE.—The balance in the unappropriated surplus account as shown by the trial balance of..... \$111,000 should be reduced by the excess of estimated income of \$1,385,000 over the estimated expenditures (\$1,360,000) of..... 25,000

To obtain the balance in the account at the beginning of the year of..... \$ 86,000

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A College	
Balance-sheet—blank date	Liabilities, reserves and surplus
<i>Assets</i>	
General current funds:	General current funds:
Unrestricted:	Unrestricted:
Cash.....	Accounts payable.....
Investments.....	Orders and contracts payable.....
Accounts receivable.....	Total liabilities.....
Inventories.....	Reserve for working capital.....
Due from endowment.....	Surplus.....
Total.....	Total.....
Restricted:	Restricted:
Cash.....	Accounts payable.....
Investments.....	Fund balances.....
Total.....	Total.....
Loan funds:	Loan funds:
Cash.....	Fund balances.....
Investments.....	
Notes receivable.....	
Total.....	
Endowment and other non-expendable funds:	Endowment and other non-expendable funds:
Cash.....	Due to current funds (temporary).....
Securities.....	Undesignated funds temporarily functioning as endowment.....
Funds in trust.....	Endowment funds principal.....
Total.....	Total.....
Funds subject to annuities:	Funds subject to annuities:
Investments.....	Fund balances.....
Unexpended plant funds:	Unexpended plant funds:
Cash.....	Replacement funds balances.....
Investments.....	Fund balances.....
Total.....	Total.....
Funds invested in plant:	Funds invested in plant:
Educational plant.....	Bonds payable.....
Agency funds:	Investment in plant.....
Cash.....	Total.....
Investments.....	Funds invested in plant:
Total.....	Bonds payable.....
	Investment in plant.....
	Total.....
	Agency funds:
	Cash.....
	Investments.....
	Total.....

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A College
Balance-sheet—blank date
Endowment
and

	General current funds		Loan funds	other non-expendable funds	Funds subject to annuities	Unexpended plant funds	Funds invested in plant	Agency funds	Total
Assets	Unrestricted	Restricted							
Cash.....	\$ 18,000	\$ 3,000	\$ 1,000	\$ 3,000	\$ 99,000	\$ 4,000	\$ 2,000	\$ 2,000	\$ 31,000
Investments.....	20,000	58,000	5,000	857,000		15,000	8,000	8,000	1,062,000
Accounts receivable.....	3,000								3,000
Inventories.....	18,000								18,000
Due from endowment.....	50,000			50,000					35,500
Notes receivable.....			35,500						100,000
Funds in trust.....				100,000					3,442,000
Educational plant.....							\$ 3,442,000		\$ 3,442,000
Totals.....	\$ 109,000	\$ 61,000	\$ 41,500	\$ 910,000	\$ 99,000	\$ 19,000	\$ 3,442,000	\$ 10,000	\$ 4,691,500
<i>Liabilities, reserves and surplus</i>									
Accounts payable.....	\$ 2,000	\$ 1,000							\$ 3,000
Orders and contracts payable.....	6,000								6,000
Reserve for working capital.....	20,000								20,000
Bonds payable.....							\$ 100,000		100,000
Undesignated funds balance.....				\$ 100,000					100,000
Replacement funds balances.....						\$ 15,000			15,000
Fund balances (surplus).....	81,000	60,000	\$ 41,500	810,000	\$ 99,000	4,000	3,342,000	\$ 10,000	4,447,500
Totals.....	\$ 109,000	\$ 61,000	\$ 41,500	\$ 910,000	\$ 99,000	\$ 19,000	\$ 3,442,000	\$ 10,000	\$ 4,691,500

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A College

Statement of current income, and expenditures
for the year ended — blank date

	General current funds
Income:	
Educational and general.....	\$1,070,000
Auxiliary enterprises.....	315,000
Other non-educational.....	15,000
	\$1,400,000
Expenditures:	
Educational and general.....	\$1,060,000
Auxiliary.....	252,000
Other non-educational.....	26,000
Appropriation expenditures—orders and contracts	6,000
	\$1,344,000
Excess of income over expenditures.....	\$ 56,000

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE — PART II

May 17, 1935, 1:30 P. M. to 6:30 P. M.

Editor, Students' Department:

Dear Sir:

In the solution of problem 1, part II, of the Institute examination in accounting theory and practice of May 17, 1935, published in the September issue of THE JOURNAL OF ACCOUNTANCY, the assumptions were made (1) that the repair and maintenance charges on the three additional vessels would be similar in amount (according to age) as the vessels already owned and (2) that the three vessels each have a useful life of 20 years.

These assumptions are far-fetched and unwarranted from the facts stated in the problem, but as the latter itself is unworkable without making such assumptions in order to arrive at a reasonable solution, this criticism is directed rather to the problem than to the published solution. The problem is faulty in that it omits details necessary for the determination of the annual costs of repairs and maintenance and of the annual depreciation on the three additional vessels. The repair and maintenance costs of the eight vessels already owned are known, their useful lives are known — these are given in the problem. As to the three additional vessels — the costs of repairs and maintenance are unknown — and as to their useful lives, one guess is as good as another. They may each have a useful life of 20 years; one, two, or all of the three of them may become absolutely unseaworthy within a shorter time. The problem leaves one groping on that point.

The three additional vessels are each similar to the other; the problem states that in language clear enough. However, no inference from the wording of the problem leads to the assumption that a "new" vessel and an "old" vessel of the same age each require the same extent of repairs or that they would

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simultaneously be placed on junk sale. If the writer of the problem had intended the phrase "three similar vessels" to mean that a "new" vessel requires the same maintenance outlay and would be serviceable just as long as one already owned of the same age and had expected his American candidates to place no other meaning, then God help us, we have been taught different English on this side of the Pacific!

Very truly yours,

(Signed) D. R. JUSTO.

Manila, Philippine Islands.

Reply:

Your comment on problem 1, part II, set by the board of examiners in the May, 1935, examination is very interesting. While the assumptions made in the solution may be far-fetched, they are the only ones that may be made on the facts given in the problem, particularly when the candidate is told that the three vessels to be purchased are "similar". A small straw to snatch at, but at least, a straw.

PREMIUM ON PREFERRED STOCK OF SUBSIDIARIES

Editor, Students' Department:

Dear Sir:

Will one of your staff be so kind as to give us an expression of opinion on an accounting problem, for which after a diligent search, we have been unable to find a solution in any text book.

The question has arisen in making up our consolidated balance-sheet, whether a premium on a preferred stock of a subsidiary company should be included in the surplus at date of acquisition of a subsidiary company in arriving at a consolidated goodwill. This preferred stock sold by the subsidiary was marketed a number of years after incorporation and a considerable number of years prior to acquisition.

We are attaching a balance-sheet setting forth our problem and we would certainly appreciate an opinion at your earliest convenience.

Yours very truly,

(Signed) RICHARD P. PEALE.

Hartford, Connecticut.

Company A purchases a 100 per cent. interest in Company B.
Company B's balance-sheet at date of acquisition.
What is the consolidated goodwill?

Company A			
<i>Assets</i>		<i>Liabilities</i>	
Fix capital	\$500,000	Current liabilities	\$ 75,000
Investment in Co. B	300,000	Long term debt	400,000
Current assets	100,000	Common stock	300,000
		Surplus	125,000
	\$900,000		\$900,000

Company B			
<i>Assets</i>		<i>Liabilities</i>	
Fixed capital	\$200,000	Current liabilities	\$ 25,000
Current assets	25,000	Common stock	100,000
		Preferred stock	50,000
		Premium on preferred stock	5,000
		Surplus	45,000
	\$225,000		\$225,000

100% ownership.

Students' Department

Reply:

In general, the total net worth, at date of acquisition, applicable to the stock purchased represents the underlying assets in which the purchasing company has an interest. This net worth should include the capital stock, surplus, (earned, paid-in, etc.), and surplus appropriations accounts.

Your question indicates that the holding company has a 100 per cent. interest in Company B. Does this include the ownership of the preferred stock which was "sold by the subsidiary . . . a number of years after incorporation and a considerable number of years prior to acquisition"? If it does, the answer to your problem is:

Net worth at acquisition:

Capital stock:	
Preferred	\$ 50,000
Common	100,000
Premium on preferred stock	5,000
Surplus	45,000
Total	<u>\$200,000</u>
Purchase price of the investment in Company B	<u>300,000</u>
Amount paid for goodwill	<u><u>\$100,000</u></u>

If, however, the purchase price of \$300,000 did not include the preferred stock (which may be assumed to have no preference in the surplus or premium on the preferred stock) the answer is:

Net worth at acquisition:

Capital stock—common	\$100,000
Premium on preferred stock	5,000
Surplus	45,000
Total	<u>\$150,000</u>
Purchase price of the common stock	<u>300,000</u>
Amount paid for goodwill	<u><u>\$150,000</u></u>

Correspondence

INCOME-TAX ALGEBRA

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: In the October issue of THE JOURNAL, F. W. Thornton criticised my article on "income-tax algebra" which appeared in the June issue. His criticism is in general fallacious, but in one instance it is valid. In my article I made the unqualified statement that "algebra is necessary" where state and federal income taxes must be computed simultaneously. His criticism of this statement is valid because, as a matter of fact, problems of this type may be solved by (1) algebra, (2) pure arithmetical approximation, or (3) arithmetical approximation based on geometrical progression.

Mr. Thornton used the third method, which is based on the following familiar formula:

$$x = y[(m) + (m^2 \cdot n) + (m^3 \cdot n^2) + \dots \text{etc. to infinity}]$$

or

$$\begin{aligned} \text{Federal tax} &= \$296,000.00[(13\frac{3}{4}\%) + (13\frac{3}{4}\%^2 \times 2\%) + (13\frac{3}{4}\%^3 \times 2\%^2) \dots] \\ &= \underline{\underline{40,812.24}} \end{aligned}$$

The fallacy in his criticism that algebra is slow as compared to his "arithmetical solution" is immediately obvious to anyone who can distinguish between the development of a formula and the application of that formula to specific problems after it has once been developed. Mr. Thornton cited page 446 and so it appears that he is laboring under the mistaken idea that I must make all the algebraic computations shown there every time I solve a problem similar to example I. He should have read page 448 where I developed a general formula which provides an "arithmetical solution" similar to his. After all, where did he get the idea embodied in his "arithmetical solution"? It is a formula, of course, and if Mr. Thornton did not develop it, then someone else did. Now after a general formula has been developed anyone may use it without recourse to the reasoning originally involved in its development. One merely applies the general formula, or as Mr. Thornton describes it, one merely makes an "arithmetical solution." Here, then, is the "arithmetical solution" based on my general formula:

2% of \$200,000.00	= \$ 4,000.00
Less 2% of 13 $\frac{3}{4}$ % (or .00275) of \$300,000.00	= 825.00
	<hr style="width: 100%;"/>
Difference	= \$ 3,175.00
	<hr style="width: 100%;"/>
Divided difference by 100% - (2% of 13 $\frac{3}{4}$ %) or 99.725%	= \$ 3,183.75 = state tax
	<hr style="width: 100%;"/>
13 $\frac{3}{4}$ % of (\$300,000.00 less \$3,183.75)	= \$40,812.23 = federal tax
	<hr style="width: 100%;"/>

"And that is all."

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Compare this to his solution and it will be obvious that one is just as good as the other. As a matter of fact, neither of our solutions could be termed purely arithmetical as both are based on a formula, and of course if any new factor is introduced, as in example II, page 448, then his formula as well as mine must be changed slightly to effect a solution. The pure arithmetical solution of example I is as follows:

<i>State tax</i>	<i>Federal tax</i>
Base \$200,000.00	Base \$300,000.00
(2) 2% of base = \$4,000.00	(1) 13¾% of base = \$41,250.00
(4) Less 2% of \$4,000.00 = 814.00	(3) Less 13¾% of \$4,000.00 = 550.00
<u>\$3,186.00</u>	<u>\$40,700.00</u>
(6) Less 2% of \$111.93 = 2.24	(5) Plus 13¾% of \$814.00 = 111.93
<u>\$3,183.76</u>	<u>.30</u>
(8) Less 2% of \$0.30 = .01	(7) Plus 13¾% of \$2.24 =
<u>\$3,183.75</u>	<u>\$40,812.23</u>
State tax	Federal tax

(Numbers in parenthesis show order of steps taken.)

In some cases pure arithmetical approximation, as shown above, is satisfactory and even desirable, but in other cases it is better to develop a general formula algebraically. The general formula then will indicate an "arithmetical solution" which anyone may apply.

In his criticism Mr. Thornton states that, "It (algebra) is not desirable because our work should be understood by clients." If our work must be understood by the client, then the extent of our professional service will be limited by the client's intelligence. Does a doctor refuse to operate because his patient can not understand the surgical technique involved? I agree with Mr. Thornton only to this extent: When there are two ways of doing a thing and when these two ways are equally efficient from the professional viewpoint, then the method selected should be that one more easily understood by the client. Perhaps this is what he meant to say. Even so, can it be assumed without question that Mr. Thornton could explain his rather involved technique with greater success than I could explain my high-school algebra? If the client can really understand why a resultant should be worn down by repeatedly multiplying by 13¾% of 2%, then I should think that the client could understand high-school algebra.

The graduated tax problem introduced by Mr. Thornton is easy. Here is my "arithmetical solution," which is merely the application of a general algebraic formula:

\$100,000.00 at 12½%	= \$12,500.00
100,000.00 at 14%	= 14,000.00
96,000.00 at 15%	= 14,400.00
	<u>\$40,900.00</u>
40,900.00 divided by (100% less 2% of 15%)	= <u>\$41,023.07</u> = federal tax

"And that is all."

It was not the purpose of my article to be instructive, but merely to advocate a simplification of the income-tax laws relative to computations required of the

Correspondence

taxpayer. Of course, if our policy is "The more complicated the laws, the better for us," then I withdraw my remarks.

Here is the type of problem that will face the Iowa corporation in 1936 under present laws to be in effect at that time:

State

Assume taxable income of \$200,000 before deducting (1) federal income tax, (2) federal excess-profits tax, and (3) contributions of \$15,000 (limited to 15% of net income before deducting such contributions).

State rate of 2% flat.

Federal

Assume adjusted declared value of \$1,000,000. Assume taxable income of \$300,000 before deducting (1) state income tax and (2) contributions of \$15,000. (NOTE.—The 1935 act provides that in determining the net income subject to excess-profits tax, the income tax for the taxable year may be deducted.)

Required.—Under the present Iowa law and the revenue act of 1935, compute federal and state income taxes.

May I suggest that the reader work this problem and then decide whether or not some simplification is advisable.

Finally, a word in defense of algebra. To me, algebra is a language which facilitates the expression of certain involved relationships. It is no more a "prop" to our reasoning power than is arithmetic or any set of prescribed symbols or rules of expression. One might just as well say that the English language is a "prop" to our reasoning power—it facilitates thinking and the conveyance of thought. An eminent mathematician's reaction to Mr. Thornton's definition of algebra reminded me of the accountant's usual reaction to the comment that "the adjustment for depreciation is a mere bookkeeping entry."

Yours truly,

HARRY H. WADE.

Iowa City, Iowa, November 5, 1935.

Book Reviews

OFFICE MANAGEMENT, by GEORGE M. DARLINGTON. *The Ronald Press Co.*, New York. Cloth, 203 pages. 1935.

A handy little manual is *Office Management* written for the benefit of the manager of a small office. In no derogatory sense one may say it is the boiled down essentials of Taylor, Leffingwell, *et al*, as applied to the office. It contains many practical and useful suggestions conducive to the smooth running of office routine.

W. H. LAWTON.

PROBLEMS IN AUDITING, by ARTHUR WARREN HANSON. *McGraw-Hill Book Company, Inc.*, New York. 2nd edition. Cloth, 556 pages. 1935.

From the Harvard graduate school of business administration comes a second edition of Professor Hanson's *Problems in Auditing* revised and much improved both by eliminations from and by additions to the first edition of 1930. Of 126 cases in the first edition, 48 have been discarded, the remainder more or less revised after several years' tests in use, and 71 new cases have been collected within the last five years. All these cases are actual ones contributed by members of the profession. Thus the student may feel assured that he is being familiarized with tested and up-to-date auditing procedure as practised by the best public accountants.

Much extraneous and practically useless matter that was in the first edition has been entirely omitted, reducing the size of the book from 750 to 556 pages. An alphabetical list of problems has been added for readier reference.

A friend discussing the first edition with me questioned the plan of the book on the ground that the "case method" rather ignored principles and that the large number of cases to be studied would only leave the student with confused ideas of what they were intended to teach. I do not think so. The cases are arranged, in the first place, in the sequence usually followed in standard practice: audit of cash, audit of securities, etc.—as main divisions, and the author then uses the clever device of heading each problem with a query which suggests the underlying principle. This seems a happy combination of theory and practice.

Perusing some of the problems with their wealth of data, I was struck by the difference between them and those to be found in the average C. P. A. examination paper. The latter usually calls for more or less elementary definitions or broad outlines of procedure, and should give little or no trouble to candidates who are presumed to have had two or three years of practical experience combined with study of standard textbooks. Yet, according to the American Institute of Accountants' *Bulletin*, 71 per cent. of the candidates failed to pass the auditing examination in May, 1935. It would be interesting to know how this compares with Massachusetts' records as to Harvard graduates; in other words how the method of theory plus haphazard practical experience compares with the Harvard systematic laboratory case method.

W. H. LAWTON.

Book Reviews

ACCOUNTING PRINCIPLES, by JAMES O. MCKINSEY and HOWARD S. NOBLE. *South-western Publishing Co.*, Chicago. Cloth, 758 pages. 1935.

Judging from the pedagogical positions held by the authors, *Accounting Principles* is a text-book on accounting theory and practice as taught at the universities of Chicago and California. In this second and revised edition some more or less extraneous matter has been omitted in the earlier chapters to make room for more details in chapters on partnerships, corporations, etc., and new chapters on creditor control (i. e. insolvencies) and supplementary statements for information.

A hint of the method of teaching is shown in the problems for class discussion closing each chapter, apparently a sort of round-table conference admirably designed to arouse the student to do some thinking for himself. Incidentally they may serve to keep the teacher on the alert also, for it is safe to say that with the discussions once started he will have many unexpected questions to answer. In addition there are laboratory problems and practice sets such as are usually to be found in text-books of this class, for which a separate pamphlet of blank working papers is furnished. An unusual feature is chapter XXXII on "Analysis and interpretation of financial statements," which may be above the heads of students in the first course but should be of value to many a business or professional man.

Exception must be taken, however, to the method of starting the closing entries to profit-and-loss (pages 100-102) by debiting the profit-and-loss account with the inventory at the beginning and the purchases during the fiscal period and crediting it with the closing inventory. It is illogical in that it makes the account apparently show that the business has suffered a loss measured by the total of the opening inventory and purchases, and has earned a profit measured by the closing inventory. Profit-and-loss account is intended to show the gross income in the credit, and the costs, expenses and losses in the debit column. Making and posting three entries where one is sufficient is a waste of time, labor and space.

One must also criticize the statement on p. 716, "It is contrary to conservative accounting and management to enter the appreciation of fixed assets in the accounts or to show it on the financial reports." That is too sweeping. There can be no valid objection to this procedure if it is based on an honest appraisal and the resulting surplus is properly segregated in financial statements. As applied to the illustrated balance-sheet under discussion it may be correct, but to state it as a general principle without qualification is apt to mislead a student or lay reader. It is fair to assume that this was an inadvertent slip on the part of the authors.

W. H. LAWTON.

Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

ACCOUNTING FOR TREASURY STOCK AND PAYMENT OF DIVIDENDS FROM CAPITAL SURPLUS

Question: A close corporation, incorporated in the state of New York, had capital stock having a par value of \$25 a share. It issued 40 shares (\$1,000) in exchange for 10 \$100 par value shares (\$1,000) of another close corporation.

Subsequently a certificate of reduction of capital stock was filed with the secretary of state, the par value having been reduced from \$25 to \$15 a share. Some time after this change was made the two corporations agreed to cancel the above-mentioned exchange of shares. The 40 shares (now having a par value of \$15 each, \$600) were received and charged to treasury-stock account, \$1,000.

When the par value was reduced a capital surplus account was credited with the full amount of the reduction. Various charges were made to this capital-surplus account at that time, and there still remains a credit balance of a considerable amount. The corporation also has a credit balance in its earned-surplus account.

The question arises as to whether the treasury-stock account should not have been charged with \$600, the present face value of the 40 shares and the excess, or \$400, charged to either capital surplus or earned surplus. Would it be in order to make such charge to capital surplus without the approval of shareholders, or should it be charged to earned surplus?

Another point relating to these 40 shares of treasury stock is that the corporation is not in the habit of purchasing its own stock, and therefore desires to know whether it would be proper to cancel this certificate and not continue to carry it as treasury stock. If this is permissible, would a resolution by the board of directors be sufficient to effect the cancellation?

When the certificate of reduction of capital stock was ordered filed by the stockholders, they conferred upon the board of directors the authority to pay dividends out of the balance of the capital surplus after charging thereto amounts otherwise authorized at the time. The certificate was filed about two

Accounting Questions

years ago and no charges were made to capital surplus other than those authorized by the stockholders. After omitting dividends for several years the corporation is about to resume payments to its stockholders. In view of the authority conferred upon the board of directors, will it be in order to charge future cash dividends to the capital-surplus account until the balance in that account is depleted or, since there is an earned surplus, must dividends be charged to that account?

Answer No. 1: In the circumstances set out in your letter, as it is not the company's intention to sell the 40 shares of the company's capital stock acquired, these shares should be reduced to their par value, viz., \$600, and the difference, \$400, written off against capital surplus created when the par value was reduced. This does not require the approval of the stockholders.

Nothing was said in your inquiry regarding the provisions of the by-laws covering the company's capital stock acquired. In some cases, the by-laws provide that all such stock must be cancelled. In the present case the directors could authorize the cancellation of the treasury stock, obtaining the approval of the stockholders later, or the stock could merely be carried in treasury. The situation should be stated in the company's accounts as follows:

Capital stock:

Authorized and issued (say).....	5,000 shares
Less: in treasury or cancelled.....	40 "
	<hr/>
Outstanding.....	4,960 shares
	<hr/> <hr/>

Presumably all stock certificates were called in at the time the par value was reduced and endorsed to that effect.

The payment of dividends out of capital surplus is permissible for corporations organized in New York which are permitted to pay dividends out of capital surplus where such surplus arises, as in this instance, out of reduction of par value representing money actually paid in. Such dividends are return of capital, and the recipients of the dividends should be advised that the dividends are return of capital and, therefore, not taxable. However, although the capital surplus was set up with the avowed intention of paying dividends out of it, the federal tax law does not permit any non-taxable dividend to be paid out of any surplus while there is an earned surplus in existence, so that if a dividend be declared, the federal government will interpret it as a payment out of earned surplus as far as the earned surplus suffices to pay it. The question of payment of dividends out of any funds other than earned surplus should always be referred to the company's attorney.

Answer No. 2: 1. In our opinion the excess of the original value of the treasury shares over the present face value, namely \$400, may properly be charged to capital surplus. There is nothing unusual in such a treatment and so it does not seem to us that the approval of the shareholders is necessary, though it may be desirable in a close corporation.

2. It would be proper to cancel the stock certificate referred to, a resolution of the board of directors being sufficient, we believe, to effect the cancellation.

3. The question, and all the pertinent facts of the case, should be submitted to competent legal authority. We, ourselves, are of the opinion that such a

distribution as is proposed probably has legal sanction, although the prudent course would be to pay cash dividends out of earned surplus before encroaching on capital surplus. Further, even though the capital surplus referred to be legally available, the propriety of a distribution therefrom is subject to the observance of equitable rights, e.g., creditors', as well as the requirement of prudent business procedure. We should add that the source of the distributions, particularly if made from capital surplus, should be intimated to the stockholders and, further, that for income-tax purposes such distributions of a close corporation would probably be held to have been made from earned surplus to the extent of that surplus.

ACCOUNTING FOR FOREIGN-EXCHANGE CONTRACTS

Question: A manufacturing company in the United States does a considerable volume of business in a number of foreign countries. Most of the sales are payable in United States dollars and present no accounting difficulties. Sales in France, however, are made through an agent and are payable in francs.

Because of the violent fluctuations in foreign exchange the company has adopted the practice of hedging its sales made in French francs by entering into contracts with its banks for the sale of French francs and the delivery of dollars, such delivery to be made at a date corresponding to the maturity of the accounts which are to be hedged.

For purposes of this proposition we assume that the company has accounts receivable payable in francs amounting to one million francs, maturing at various dates within three months following the close of the year and that the United States dollar value of these accounts was covered at \$59,000 thus giving an average rate of 5.9 cents per franc. Let us further assume that the company has been in the habit of using a fixed par rate of 4 cents per franc in converting transactions between its French branch and the United States. The actual market value of the franc at December 31, 1933, as quoted in the *Financial Chronicle* was 6.1991 cents per franc. The following questions present themselves to us at this time:

1. What rate should be used in converting these French accounts receivable to United States currency at the close of the year? The usual rule, of course, is that such items should be converted at the current rate at the close of the year, but it seems to us that as the company has limited itself to the amount it will get out of these accounts by selling francs against the forward dollar deliveries these receivables should be converted at the average rate at which the accounts were hedged.

2. As stated earlier in the proposition commitments are made for deliveries of dollars at the approximate maturity of the accounts hedged. It therefore seems evident that the company is protected against exchange losses so long as the accounts are collected on or before the date on which delivery of dollars is to be made. However, if the accounts are not paid the company does not have francs to make delivery against its dollar purchases and it must then either purchase francs or extend the contract. In either case the company will make a profit or a loss, at the time it purchases francs or renews the contract, to the extent of the difference between the rate of exchange then prevailing and the rate prevailing at the time the contract was originally made. Is this recognized as a contingent liability which should be stated in the balance-

Accounting Questions

sheet? Is there an actual asset in dollars and an actual liability in francs which should be stated?

3. In this particular instance all contracts for future exchange are made by the agent in France and the company does not receive detailed information about these contracts until a considerable time afterward. It is our understanding that the bank makes no charge against the company at the time these contracts are made and the company makes no entry on its books to reflect the existence of these contracts. The only entries appearing on its books are the entries recording the brokerage paid on these contracts when executed and the profit or loss which may be made when contracts are extended because of failure of customers to pay at maturity dates. What is considered to be the best method of recording such exchange contracts in the books?

Answer: 1. In the circumstances it seems to us that the usual rule as to conversion at the current rate does not apply, and we agree that the receivables in question should be converted at the average rate at which the accounts were hedged.

2. If the accounts are not paid at the agreed date, it seems to us, the profit realized on the loss sustained by the company on settling its hedge or renewing the contract should be brought into the accounts as completed transactions. When the maturity date succeeds the date of the balance-sheet so that the customer's failure to pay is not known until after the date of which the accounts are prepared, then we believe provision should be made for the loss, or in the alternative—possibly the preferred treatment—a footnote should be appended to the balance-sheet in some such terms as follows: "At December 31, 1933, the company had exchange commitments in which there is an indicated loss of \$"

3. Record should be made in an appropriate register of such commitments as those referred to, but no entry is required in the books of account until the contracts mature, the further procedure being that outlined in "1" and "2" above.

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