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EDITORIAL

The Proposal to Tax Undistributed Corporate Profits

The proposal to tax undistributed corporate profits, perhaps the most extraordinary among the many plans devised for the infliction of taxes upon the American public, is now before the senate of the United States. It is impossible to comment upon the suggestion as a fact because no one knows what changes may take place before any tax bill, even remotely resembling the original proposal, will become law. The matter, however, is of such tremendous potential importance that it is the subject of daily comment, and to no one more than accountants are its academic aspects vitally significant. The bill, which was introduced in the house of representatives and passed by obedient members of that assembly, would have brought about a complete change in the whole system of the federal taxation of corporate profits. The plan seems to have been devised without careful consideration and without any recognition at all of the existing conditions or the effect which it would produce, with the probable exception of a hope that it would afford another opportunity for socialistic adventure. When the plan was first propounded the business public was aghast. Men could not believe that such a proposition was seriously offered by a government pledged to assist in the rehabilitation of distressed commerce and industry. In brief, it called for an exceedingly complicated computation and a confiscatory assessment upon the undistributed income of corporations. No one in the administration seems to have remembered that it is impossible to distribute all profits and survive. Growing companies starting from small beginnings, which it is clearly to the country's best interests to encourage, would find the proposed tax an insuperable obstacle to progress, while decadent companies and those exploiting this country's natural resources would find themselves relieved entirely of taxation, since they would ordinarily distribute their total earnings as dividends. All companies would be driven to distribute as dividends the largest part of their earnings in good times and would not be able to maintain their dividends during times of depression, such as that through which we are passing, in which the dividends distributed largely exceed the profits earned.

Opposition Wide-spread and Insistent

Opposition to the bill arose instantly, but the public seemed to understand that opposition in the house of representatives would be futile, and the protests, therefore, were directed to the senate. Leaders of industry, economics and accountancy presented arguments at the hearings of the finance committee which were absolutely unanswerable, and gradually it began to dawn upon senators that the bill in its original form must not pass, lest its enactment drive out of business a great many of the corporations, which, through good years and bad, have been struggling to establish American business on a permanent basis of prosperity, without which no part of the public can prosper. The American Institute of Accountants, through its committee on federal taxation, presented a memorandum to the senate committee which was a model of restraint and logical discussion. It pointed out the extremely impracticable nature of the bill and demonstrated by illustration the difficulties of assessment and the effect of a tax imposed as described in the bill. It is to be hoped that the members of the finance committee will find time to read and consider the arguments adduced by the committee of accountants. It was gratifying to the accounting profession to read the very able presentation of arguments against the bill offered by George O. May, in his individual capacity. Although Mr. May had been a technical advisor to the treasury, his knowledge of his subject was chiefly based upon his wide experience as an accountant, which enabled him to speak with authority. The cordial reception extended to his remarks by the finance committee was an indication of the conclusive nature of his plea. Largely to him and to other men of knowledge is due the sentiment which has been created against enactment of the bill in its original form. Mr. May's challenge of the statements emanating from the secretary of the treasury evidently carried conviction. The explanation offered in reply by the secretary of the treasury was one of those typical administration efforts which usually say in effect, "Trust us and all will be well." But the time, we hope, has passed when both houses of congress will swallow such obvious bait. As this issue of THE JOURNAL OF ACCOUNTANCY goes to press the matter is still on the knees of the gods.

Telling Half the Truth

For some reason the British courts seem to be peculiarly productive of decisions which have a bearing upon the whole world of finance and, especially, upon that zone of the financial world in which accountants live and move and have their being. It is only a few years since the celebrated affair of the Royal Mail Steamship Company, known as the "Kylsant case," was tried and decided in an impartial manner which aroused the admiration of everyone. The prominence of the principals concerned in the matter did not affect in any degree the findings of the jury nor the sentence of the court. That case, as everyone probably remembers, involved a question of a prospectus which told the truth, but told it in a misleading way. Earnings of the company over a period of ten years averaged a certain amount, which the prospectus correctly stated, but the vitally important points that all the earnings had been made in the first few years of the decade and that there had been a consistent deficit in the latter years was not revealed. Now comes a somewhat similar trial which has been generally described as the "Pepper case." It was heard first in the Central criminal court, London, before Justice Atkinson. The defendants were prominent men in the city of London and the defense and prosecution were conducted by eminent members of the bar. This was another case of a prospectus which it was alleged did not reveal the truth in a way which would prevent misunderstanding. The jury found the defendants guilty and by consent of the court the case was then appealed to the court of appeal. After arguments lasting more than two days the lord chief justice, Lord Hewart, and Lords Macnaghten and du Parcq on March 18th dismissed the appeals in the case.

Investors Beguiled by Silence

In this country we are not concerned with the identity of the defendants, but the judgment of the court of appeal should be taken to heart here and everywhere else by all who have to do with the preparation and publication of prospectuses which are intended to attract investment. The charges in the case were two: First, the defendants were charged with making a false statement in a prospectus with intent to induce persons to become shareholders contrary to section 84 of the larceny act of 1861. The particulars were thus described:

"Garabed Bishirgian on September 3, 1934, being a director of a certain public company, James & Shakespeare, Ltd., made, circulated or published, or concurred in making, circulating or publishing, a certain written statement, a prospectus, which he knew to be false in a material particular, with intent to induce persons to become shareholders in the said company. Howeson and Hardy aided and abetted the said Bishirgian to commit the said offence."

The second count alleged that a conspiracy existed between the three men in contravention of section 84 of the larceny act. The section of the larceny act to which reference is made reads as follows:

"Whosoever, being a director, manager or public officer of any body corporate or public company, shall make, circulate or publish, or concur in making, circulating or publishing, any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder or creditor of such body corporate or public company, or with intent to induce any person to become a shareholder or partner therein, shall be guilty of a misdemeanour."

The chief justice referred to a case tried in 1900 when Lord Macnaghten had said: "It is a trite observation that every document, as against its author, must be read in the sense which it was intended to convey, and everybody knows that sometimes half a truth is no better than a downright falsehood." Lord Hewart then referred to passages from other judgments and said:

"There can be no doubt that the law which is applicable to such a case is perfectly clear. The expression of the law varies. The meaning remains identical. If a statement is impugned under this section it is because there is such a partial and fragmentary statement of fact that the withholding of that which is not stated makes that which is stated false. Or to use other words, 'such a non-disclosure as to render the document misleading,' or 'the non-disclosure must be the non-disclosure of something the disclosure of which would falsify some statement in the prospectus.'"

In brief, the prospectus, it was alleged for the crown, had not disclosed the purpose for which the capital to be derived from the sale of securities would be used. It appears that nothing was said about the attempt to corner the pepper market of the world and nothing was said about an adventure in shellac. To quote again from the words of the lord chief justice:

"The argument is not that in this or that particular this prospectus was untrue. The argument is that its whole purpose and effect were to deceive. It is said that no suitable words could have been included in the prospectus to repair the omission. It is not quite clear what that proposition means. If suitable and true words had been there it might well be that the prospectus would not have been of much use. Suppose there had been a note: 'N. B.—You are apparently being invited to subscribe in a well known old established ordinary business carrying on its operations on approved lines. You are really being invited to trust your money to a gambling speculation to make a corner in pepper.' It would have been the truth but the utility of the prospectus might have been extremely small."

The court of appeal dismissed the appeals of the three defendants and allowed the sentence of imprisonment to stand.

Truth Must Be Intelligible

So far as we are aware there have been no cases in the American courts quite analogous to the Pepper case or to that of the Royal Mail Steamship Company, but it is not reasonable to suppose that we shall long escape something of the sort. Here in America most of the cases in which accountants are most vitally interested are of the nature generally described as "strike suits" —namely, efforts to extort by a thinly disguised system of blackmail sums of great or small amount from accountants who have rendered reports of audit upon which the plaintiffs in the strike suits have sought to base claims for damage or other loss. Again, it may be pointed out that while the history of American finance is not utterly stainless, there has been an increasing effort to make every prospectus conform to the truth and to present the truth in a way that even the moderately aware may understand. We do not have here so great a respect for an established name that the public will rush in and invest without some preliminary investigation. The falsity which is the cause of most bad investments in this country may be laid at the door of the smooth salesman or the unscrupulous brokerage house. The company whose securities are offered for sale is, generally speaking, reasonably honest. We all believe that we are coming soon into a time when business will resume its upward trend and the great accumulations of money which are now held idle will be brought out and put to work. Then will be a time of severe temptation to the makers and the issuers of prospectuses. Accountants will be called in, and upon them will rest a great responsibility to see that every bit of literature uttered for the purpose of attracting investors shall tell the truth, the whole truth and nothing but the truth—and, beyond that, shall tell the truth in a way which can not be misinterpreted. It is easily possible to describe the condition of a company by selective references, each one of which may be absolutely true, and yet to make the effect of the whole absolutely false by failing to point out the weaknesses. We do not know, of course, what result would attend an attempt to prosecute for the utterance of a false prospectus in this country. Unfortunately there have been a few glaring cases in which persons who seemed to most of us to have been guilty of misleading the investing public have been acquitted, sometimes for reasons difficult to grasp or unpleasant to admit. We believe, however, that the sentiment of the average American jury would be strongly in favor of a grave penalty for anything which savored at all of misrepresentation. The accountants who will be involved in these cases of the future may well be on their guard lest by inadvertence they permit the issuance of any statement of affairs or any descriptive literature in support of an attempted flotation of securities which could mislead anyone not expert in the finesse of finance. Indeed, as one looks over the whole field of the probable future he can not escape an increasing conviction that upon the accountant will rest a burden greater than any which he has borne before.

A Suggestion for Politicians

A correspondent, E. Clemens Horst, has written a letter on the subject "The need of the whole truth" from which we have great pleasure in quoting a few excerpts. He says:

"Because of the mass of widely conflicting publicity now being put before the public concerning our governmental affairs, there is great need of real accountancy to enable the public to know the whole truth, in distinction from partial truths, about important representations made by our partisan political and our partisan business leaders.

"From partisan leaders nearly all reports are either gloriously optimistic or hopelessly pessimistic, dependent upon the interests of such leaders. It is in such a position that real accountancy is essential in the public interest. By real accountancy is meant the kind that any bank or business house requires when planning the financing of a proposed client.

"If it be true that our farmers and our country are in economic distress, the restoration of their prosperity will depend upon the public being told the truth, and the whole truth, about the important factors concerning our farm and national affairs.

"By way of illustration, our government is now persistently drumming into the minds of our public that our foreign trade is increasing and that such increase is beneficial to our farm and other producers and to their labor. In such publicity, statistics are quoted which, unless analyzed, appear to be convincing that we are on the road to recovery. Yet an analysis of our recent increase in foreign trade shows that, except as to automobiles, machinery and a comparatively few other items, our exports are either of our irreplaceable and eventually needed natural resources or they are of farm products and commodities sold for export for less than their gross cost of production, based upon a fair American wage scale, and that our increases in imports are mostly of directly and indirectly competitive farm and factory products.

"Our increases in exports are mostly of commodities produced by 'mass production' requiring little labor, while our imports are mostly of individual production requiring much labor. This adverse situation is intensified against us by the fact that in nearly all foreign countries the wage scales are much lower and the working hours much longer than in the United States, besides which the foreign countries have much child and so-called 'sweat shop' labor.

"In the so-called planning of our farm acreage we talk much about our agricultural surpluses, while we have planned and are carrying out our plans to multiply our competitive imports, in face of our reducing our home production by soil conservation and other schemes to fit our increased importations of farm products.

"What our public needs, especially from now until next election day, is immediate and fair criticism of the most important addresses by our public leaders, both Republicans and Democrats, so as to give to the public, in impartial form, at the time of such addresses, the high lights on the various questions, which the keynote leaders have intentionally or unintentionally omitted from their partisan presentations of the questions at issue."

As all our readers know, THE JOURNAL OF ACCOUNTANCY always refrains from any discussion of partisan politics. It is not the purpose or desire of anyone concerned with the editorial policy of this magazine to further the election of anyone because he is a Democrat or a Republican, but we believe we can speak for all our readers when we advocate the election of those men, whatever their party may be, who will have so deep a respect for the truth that no question of political expediency can affect their legislative action. Perhaps the best solution of the difficulty which will confront us next fall would be to have every candidate for every office in the land submit his statistics and the bases of his arguments to engineers, statisticians and accountants for verification before utterance. This might make the campaign speeches lacking in oratory or scenery, but it would be a blessed change nevertheless.

Effects of Competitive Bidding

A correspondent writes on the subject of competitive bidding and expresses accord with the efforts which are being put forth to eliminate the practice. He says:

"However, in the final analysis, there is one sure teacher, and that is experience. The thought occurred to me that possibly you could show some of the results obtained by the acceptance of the lowest bid. This is a rather difficult point to cover, but it may be that you have some specific instances in mind where work done on a low bid basis was entirely unsatisfactory as far as the ultimate purpose desired was concerned. If such could be stated it would help to round out the argument."

There are indeed many instances of the unsatisfactory results which followed acceptance of the lowest bid, but it is not as simple a matter as it seems to say "Lo, here!" or "Lo, there!" To begin with, it is the common experience that faulty work is not always instantly discoverable, and it is only after a lapse of time that the shortcomings are evident. Then, again, it is not expedient to listen too credulously to the allegations of other accountants who may have submitted bids which have not been accepted. Even in the rare atmosphere of the professions jealousy occasionally rears its verdant head. To ask the officers of a county or city to testify to the unworthiness of the so-called accountants whom they themselves have chosen would be to expect an impartiality not often found this side of Heaven. It is, therefore, not easy to obtain evidences of what everyone knows. The surest demonstration of the fallacy of the bidding-for-work principle is derived from the application of analogy and common sense. It stands to reason that the lowest bid usually is based upon scant performance or a too keen desire to obtain work. Either of these causes leads to poor results. No man can undertake a task at a price which is not profitable without a sore temptation to omit everything that can be omitted. Generally it is true that the lowest price will buy the least desirable article, whether that be commodity or personal service. It is probably always true in the latter case. And so confidential a matter as an audit is the last thing in the world that should be dragged into the open market.

Bidding Is Logically Unsound

If the client have not a complete faith in the integrity and fidelity of the accountant there should never be an attempt to establish the relationship of client and auditor. If on the other hand the client have faith in the selected auditor the question of fee should be secondary. The great point is to obtain a fair and independent expression of opinion founded upon the results of searching investigation and thorough analysis. If that has been assured it will be time enough to talk about the fees which shall be paid. There are two prime reasons for the continuance of competitive bidding. The first and more deplorable is the acquiescence of the accountant who bids. Did all accountants flatly refuse to bid the evil practice would end over night. The second cause is the ignorance of officers, required by law or regulation to make all purchases after calling for bids, who can not discern the difference between buying a ton of coal and the services of an auditor. It seems to be almost hopeless to look for wisdom in a group of city politicians who think that artichokes and audits are much alike in nature though different in appearance. As our correspondent surmises, we do know of audits which have fallen far short of perfection because they have been entrusted to political favorites, to low bidders or to men whose only claim to professional status was the self-imposed appellation "accountant." But there need not be utter dismay. Competitive bidding like many other diseases of childhood will be cured, and preventive medicine will protect the next generation from the ills that presently afflict us.

AMERICAN INSTITUTE OF ACCOUNTANTS' EXAMINATIONS

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants, May 14 and 15, 1936.]

BOARD OF EXAMINERS

Examination in Auditing

MAY 14, 1936, 9 A. M. TO 12:30 P. M.

The candidate must answer all questions.

No. 1 (9 points):

(a) Define contingent assets and contingent liabilities.

(b) Give two examples of each definition.

(c) How should each of your examples be shown on the balance-sheet?

No. 2 (5 points):

The balance-sheet of the A Corporation shows as a fixed liability "First mortgage bonds, $100,000." On inquiry you learn that these bonds mature within the next six months, and you inform the treasurer that you propose to show the item as a current liability. He explains that steps are being taken to refund the liability by a new issue of bonds at a lower rate of interest. From a survey of the finances of the corporation you are convinced that it will have no other means of meeting the debt.

It so happens that another client of yours owns 90% of the bonds, and has boasted to you that he will soon obtain full possession of the A Corporation which is a business rival.

(a) What use will you make of this knowledge?

(b) How will you treat this item on the A Corporation balance-sheet? Give your reasons.

No. 3 (8 points):

The Retail Hardware Corporation purchased on December 31, 1930, a cash register for $1,500, paying $500 down and giving a series of notes of $100 each, payable on December 31st of the ten following years. In your audit for the year 1935 you find this item stated in the "cash register" account and on the balance-sheet at $900. The bookkeeper explains that the corporation does not consider the register as its property until all the instalment notes have been paid, although the bill of sale passes the title unconditionally.

(a) State what entries should be made to show the facts. (Assume depreciation at 6%.)
(b) How will they be shown on the balance-sheet?
(c) What explanation will you give the bookkeeper in support of your instructions?

No. 4 (5 points):

Why should depreciation be deducted on the operating statement as an item of cost and before rather than after showing net operating profit?

No. 5 (5 points):

Your client, a manufacturer in a small way, occupies rented land and has signed a lease for twenty-five years which does not contain a renewal clause. On the land he has erected a building having an estimated life of fifty years. On his books you find he has charged depreciation at the rate of 2% per annum.

(a) Will you approve this rate?
(b) Would you approve it if the lease had contained an option to renew for twenty-five years longer?

Give your reasons for both answers.

No. 6 (12 points):

Your client, a physician, married and living with wife, hands you a memorandum of his income and expenses for the calendar year 1935 from which to prepare his income-tax return, viz.:

(1) Income from his profession as physician		$10,000
(2) Net loss from operations of farm where he maintains a country home		1,000
(3) Net loss from rental of sea-shore home for summer, viz:		
Rents received	$ 300	
Repairs and depreciation	600	300
(4) Gain from securities sold—bought in 1920		5,000
(5) Gain from securities sold—bought in 1931		1,000
(6) Loss from securities sold—bought in 1926		8,000
(7) Gain from real estate sold—bought in 1924, viz:		
Cost of land	1,000	
Cost of brick office building, new	7,000	
Total cost	8,000	
Sold for	10,000	2,000

(8) Interest paid..................................	2,000
(9) State and municipal taxes paid....................	500
(10) Federal income tax for 1934 paid..................	700

State how each of the above items should appear in correct amounts on the return, and what will be the client's net income subject to normal tax.

No. 7 (12 points):

What is the auditor's duty with regard to each of the following accounts before certifying to the balance-sheet on which they appear? Where should they be shown on the balance-sheet?

(a) Reserve for depreciation.
(b) Reserve for restoration of leased property.
(c) Reserve for contingencies.
(d) Reserve for bond sinking fund.
(e) Reserve for income taxes:
 1. In the case of an interim balance-sheet.
 2. In the case of a final annual balance-sheet.

No. 8 (14 points):

State your reasoned objections to the form and the substance (a) of the various numbered parts of the following certificate and (b) of the certificate as a whole:

AUDITORS' CERTIFICATE

(1) We have audited the books, accounts and records of Adam & Smith, Inc., as at December 31, 1935, and (2) certify that, (3) subject to the realization of the accounts receivable and the inventories, (4) the attached balance-sheet is a true and correct statement of the company's financial position for the year. (5) We further certify that the accompanying profit-and-loss account as at December 31, 1935, is (6) true and correct according to the books.

JONES, BROWN & CO.

No. 9 (8 points):

How should an auditor verify the book record of:

Directors' fees.
Officers' salaries.
Commission paid to officers.
Officers' traveling expenses.

No. 10 (12 points):

(a) State briefly what information you would expect to obtain from the following ratios, viz.:

(1)	Operating profits	to Operating capital employed,
(2)	Net sales	to Operating capital employed,
(3)	Working capital	to Operating capital employed,
(4)	Net sales	to Gross fixed assets,
(5)	Net sales	to Receivables,
(6)	Cost of goods sold	to Inventories,
(7)	Net worth	to Total assets,
(8)	Current assets	to Current liabilities,
(9)	Cash	to Current liabilities,
(10)	Net income	to Net worth.

(b) When does the information become really useful?

No. 11 (10 points):

(a) On what basis of valuation should the general fixed properties of a municipality be carried on the books? Give reasons for your answer.

(b) Should any different treatment be applied to similar property of utilities operated by the municipality? Give reasons for your answer in this case also.

Examination in Accounting Theory and Practice

PART I

MAY 14, 1936, 1:30 P. M. TO 6:30 P. M.

Solve problem 1 or 2 and all other problems.

No. 1 (20 points):

You are engaged to audit the accounts of a city for the year 1933. The books as you find them show the following information as to the general fund:

Surplus at beginning of year	$332,011
Taxes assessed	184,400
Other revenues collected	56,841
Expense, per vouchers approved	227,642
Surplus at end of year	345,610

On investigation, you discover the following additional facts:

(a) The assets of the fund include the inventory of general stores—$23,812. A continuous inventory of about this amount is maintained, the council having authorized such an inventory up to $25,000.

(b) The assets of the fund also include book value of permanent property, which on January 1st totaled $269,362 and on December 31st, $286,962. The difference represents capital expenditures for the year charged direct to fixed-asset accounts.

(c) On December 31st, orders and contracts were outstanding estimated to cost $4,350, payable out of the appropriations of the year 1933.

(d) Taxes for the year were due May 1st, but only 82% had been collected at December 31st. Estimates indicate further collections of not over 8%.

(e) Amounts due the sinking fund from the general fund for the year totaled $9,212, of which $6,000 was paid and included in expense.

(f) On January 2, 1934, a public benefit instalment of $3,178 is due the assessment fund. A similar instalment, due January 2, 1933, was paid in 1933 and entered as an expenditure of that year.

(g) Included in the expense of the year under audit are the following sums paid for departments entirely supported by special funds: library, $1,687; parks, $2,143.

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1. Does the surplus as stated at the beginning and the end of the year correctly indicate the amount available for appropriation and expenditure on those dates? If not, prepare working statements to indicate the adjustments you would consider necessary in each amount.
2. Present also a correct statement of general-fund revenue, expenditure and available surplus for the year.

No. 2 (20 points):

The operations of K. Inc. for the fiscal year ended June 30, 1935, are expressed in the following table of percentages:

	Per cent.
Sales	100.00
Cost of sales	66.67
Gross profit	33.33

Expenses:		
Selling and delivery	10.00	
Administration and general	7.50	17.50
Net profit		15.83

There was no inventory at the beginning of the fiscal year and during that year the company, operating at full capacity, produced 10,000 units, of which 8,000 were sold. The materials, labor and overhead were, respectively, 35%, 45% and 20% of the cost of production.

The current year's costs are expected to show increases as follows: materials, 15%; labor, 10%; overhead, 20%. On the other hand, it is expected that, because of more efficient methods, the production will be increased 10%, and you are to assume that this is accomplished without additional increases in the cost of production.

Negotiations are pending with S & R who are prepared to purchase K. Inc.'s entire output for the current year, together with the stock on hand at the beginning of the current year, if the parties can agree on a price. In that event the amount of the selling and delivery expense would be reduced 75%, and there would be no change in the amount of the administration and general expense.

Accepting the indicated changes in costs and production, what percentage of increase or decrease in the 1935 selling price per unit would enable K. Inc. to realize, under the contemplated arrangement, a net profit of 20% on the sales?

No. 3 (25 points):

The plant of the Tamarack Manufacturing Company, engaged in the manufacture of hunting and camping articles, was partly destroyed by fire on the night of September 1, 1935. Practically all books of account were burned, but the data given below were obtained from various sources.

Balance-sheet January 1, 1935

Assets		*Liabilities*	
Machinery and fixtures	$ 47,000.00	Notes payable	$ 4,729.50
Automobiles	3,494.40	Accounts payable	2,553.60
Liberty bonds	10,000.00	Reserve for depreciation	8,437.50
Customers' accounts	35,524.00	Capital stock	100,000.00
Inventory	50,000.00	Surplus	59,220.90
Cash	28,923.10		
	$174,941.50		$174,941.50

An analysis of the cheque book and cancelled vouchers revealed the following receipts and payments:

Receipts		*Payments*	
From customers......	$ 98,746.70	Notes payable.......	$ 917.50
Notes payable.......	34,376.00	Accounts payable....	42,584.20
Interest on bonds....	237.50	Machinery..........	3,750.00
		Labor..............	77,366.40
		Administrative salaries	9,675.28
		Selling expenses......	11,900.00
		Sundry manufacturing expenses..........	646.62
		Rent...............	4,000.00
		Office expenses.......	2,418.50
		General expenses.....	2,381.40
	$133,360.20		$155,639.90

A report rendered to the president on September 1, 1935, showed that $172,952.10 was receivable from customers and $24,457.50 was due to creditors (accounts payable).

There should be a charge of $1,012.50 for depreciation to September 1, 1935, and the automobiles should be written down to $3,000.

An inventory of the merchandise not burned was valued at $20,000. The insurance company agreed to accept the inventory of the company as before the fire if calculated on a basis of average gross profits at 35% of the sales. The company's inventory was insured for $30,000 on an 80% co-insurance policy. There was a $5,000 loss on machinery and fixtures which the insurance company also agreed to pay.

From the foregoing data:

(a) Reconstruct the accounts of the company, and show the method followed.

(b) Prepare (1) a balance-sheet as at September 1, 1935, which is to include the liability of the insurance company and (2) a profit-and-loss account for the eight months ended on that date, showing details of cost of sales.

No. 4 (20 points):

From the following data prepare a consolidated balance-sheet of the Alpha Company and subsidiaries as at December 31, 1934:

	December 31, 1934		
	Alpha Co.	Beta Co.	Gamma Co.
Cash in banks and on hand	$ 30,000	$ 10,000	$ 15,000
Customers' notes and accounts receivable	90,000	50,000	60,000
Inventories	70,000	60,000	50,000
Investments at cost			
Stock of Beta Company—75%	100,000		
" " Gamma " —80%	200,000		
Property, plant and equipment, less reserve for depreciation	500,000	200,000	120,000
Investment at cost			
Stock of Beta Company—15%			30,000
Deferred charges	10,000	5,000	5,000
	$1,000,000	$325,000	$280,000
Notes payable	$ 60,000	$ 50,000	$ 30,000
Accounts payable	40,000	45,000	20,000
Mortgage on plant			90,000
Capital stock—par value $100 a share	500,000	200,000	100,000
Surplus	400,000	30,000	40,000
	$1,000,000	$325,000	$280,000
Surplus:			
Earned surplus at December 31, 1933	$ 280,000	$ 10,000	$ 50,000
Income for year 1934	70,000	20,000	30,000
Increase on appraisal of land as at January 1, 1934	100,000		
	$ 450,000	$ 30,000	$ 80,000
Dividends paid	50,000		40,000
Surplus at December 31, 1934	$ 400,000	$ 30,000	$ 40,000

The Alpha Company acquired its holdings in "Beta" and "Gamma" on December 31, 1933.

The Gamma Company's holding of Beta Company stock was purchased at an earlier date at par, which was also the book value.

No. 5 (20 points):

The members of the firm Stewart & Co., the balances in their capital and current accounts at the end of the fiscal year and the ratios in which they share the profits are as follows:

	Capital accounts Cr.	Current accounts Dr.* Cr.	Share of profits
Stewart	$100,000	$20,000	35%
Green	50,000	30,000	25%
Jones	30,000	7,000*	20%
Smith	20,000	3,000*	20%

The balances in the partners' capital accounts represent the capital originally contributed by each one.

The firm at the end of the fiscal year has sold its entire business to the Stewart Corporation for $300,000, which is the actual net worth of the firm, as agreed between the partners, and the firm has received 3,000 shares of the corporation in full payment. The corporation has thus acquired all the firm's assets and assumes all its liabilities recorded on the books, including the balances in the partners' current accounts.

The four partners intend to retain the same interest in the capital stock and the profits of the corporation as they had in the profits of the firm.

1. You are required to show the settlement between the partners.

2. What will be the settlement between the partners if, under the otherwise unaltered terms of the sale, the corporation does not take over the balances in the partners' current accounts and these balances are settled between the firm and its partners before the sale is consummated, so that the firm's total liability to the individual partners may be restored to the amount of capital originally contributed?

3. What will be the settlement between the partners if, under the otherwise unaltered terms of the sale, the corporation does not take over the balances in the partners' current accounts and the partners agree among themselves that, for purposes of the settlement, these balances are to be transferred to their respective capital accounts?

No. 6 (7 points):

On July 1, 1927, a company issued $1,000,000 in bonds at a discount of 10%. These bonds were to mature as follows:

July 1, 1932	$ 100,000
" 1933	100,000
" 1934	100,000
" 1935	100,000
" 1936	100,000
" 1937	500,000
	$1,000,000

On July 1, 1935, the company purchased $50,000 (par value) of bonds maturing on July 1, 1936, at 85 and retired them.

What entry should be made on July 1, 1935, to record the purchase?

(The solution should be based on the "bond outstanding method".)

No. 7 (8 points):

The Mean-Well Company allowed its employees to subscribe to its capital stock on an instalment basis. The number of employees and the shares subscribed by each were as follows:

Number of employees	Shares subscribed by each	Total shares
5	1	5
10	2	20
25	5	125
10	10	100
10	25	250
2	50	100
2	100	200
64		800

After all subscriptions were paid the company distributed pro rata 352 additional shares as a special bonus or donation. No fractional shares were to be issued. Employees entitled to less than ½ share received from the company an equivalent in cash at $50 a share; employees entitled to more than ½ share paid the company at the same rate for the scrip necessary to round out their holdings. No deviation from the plan was permitted.

Prepare (1) a columnar schedule showing the number of shares subscribed by and distributed to each employee, the fractional shares sold or bought and the cash paid or received by him; also prepare (2) a summary of the schedule, showing aggregates.

Examination in Commercial Law

May 15, 1936, 9 a. m. to 12:30 p. m.

Reasons must be stated for each answer. Whenever practicable give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions.

Group I

Answer all questions in this group.

No. 1 (10 points):

Parker, a certified public accountant, made an audit of Thornton's books of account and rendered a financial report which Thornton used in obtaining credit. Answer each of the following questions, giving legal arguments or reasons for each answer:

(a) If Thornton is sued by a creditor who had not seen Parker's report, can Parker, as a duly subpoenaed witness, decline to disclose business information procured by him during the conduct of his audit but not incorporated in his report?

(b) If Thornton is arrested and tried in a criminal proceeding, can Parker, as a duly subpoenaed witness, decline to disclose such information?

(c) Can Thornton compel Parker to turn over to him an analysis (in pencil) of an asset account made at Parker's request and for his assistance by Thornton's bookkeeper during the conduct of Parker's audit?

(d) Can Thornton compel Parker to turn over to him an analysis (in pencil) of the asset account referred to in question (c) made by one of Parker's assistants during the conduct of his audit?

(e) Can Parker by his last will and testament bequeath all of his working papers to a legatee?

No. 2 (10 points):

The certificate of incorporation and the by-laws of a corporation provided that management of it was vested in its board of seven directors. A deed to land owned by the corporation was prepared in the name of the corporation and was signed by each director, but no two directors signed at the same time or place and no meeting was held or resolution passed. There were several hundred stockholders and three of the directors were not stockholders. Was the deed effective to pass title?

No. 3 (10 points):

What elements or factors must exist in order to constitute a fraud sufficient to vitiate a contract?

No. 4 (10 points):

Hawkes and Andrews were public accountants practising under the firm name of Hawkes and Andrews. Without the knowledge of Hawkes, Andrews borrowed money on a promissory note signed and endorsed by him individually and then endorsed by him with the firm name. He used the money thus borrowed for regular and ordinary expenses of the firm. In an action on the note, by the payee, can judgment be obtained against Hawkes?

No. 5 (10 points):

What is the difference between a sale and a contract to sell and of what importance is the distinction?

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if more are submitted only the first five will be considered.

No. 6 (10 points):

Eight men signed, acknowledged, filed, and recorded a paper purporting to be a certificate of incorporation under a state statute. They then issued capital stock to themselves, elected directors and officers, adopted by-laws and began to do business. The purposes of the corporation stated in the paper so executed and filed were not authorized by the statute under which incorporation was attempted and the place where the business was to be conducted was not stated therein as required by the statute, but these errors were not detected in the office of the secretary of state until after the organization had been completed and some business had been transacted.

(a) Can the state successfully question the legality of the corporation?

(b) Can the eight men be sued as partners by a person dealing with the alleged corporation prior to any action by the state?

No. 7 (10 points):

A young man 20 years and 11 months of age who looked 25 years of age misrepresented himself to be over the age of 21 and made a contract for the purchase of and did purchase an article which was not a "necessary" for which he would be liable. Has the vendor any remedy in a civil (not a criminal) action?

No. 8 (10 points):

Martin, a licensed insurance broker, procured a new policy from an insurance company, delivered it to the assured, and collected the premium. He then notified the company that he had collected the premium and the company sent him a bill for the premium payable in 60 days. The policy contained a provision to the effect that the broker was an agent of the assured and not of the insurance company. Martin failed to pay the amount of the premium to the company and thereupon the company sent a notice to the assured cancelling the policy for non-payment of the premium. Must the assured again pay the premium to avoid cancellation of the policy?

No. 9. (10 points):

Formal notice of presentment and dishonor of a promissory note was not mailed or otherwise given to an indorser. Upon the trial of an action brought against him, the testimony showed that the indorser had said to at least one witness that the maker "is having trouble with his creditors and I don't believe he will be able to meet this note at maturity." It further appeared that the indorser had arranged with the maker a plan whereby the maker could pay the note in instalments. Is the defense of lack of notice an effective bar to the action against the indorser?

No. 10 (10 points):

What are the legal requirements in your state as to witnesses and other formalities for the proper execution of a last will and testament? (Name the state to which your answer relates.)

No. 11 (10 points):

Give a general description of the plan provided in section 74 of the National Bankruptcy Act which makes it possible for a person, other than a corporation, in financial difficulty to petition for a composition with creditors or for an extension of time in which to pay his debts.

No. 12 (10 points):

Colley, who was a promoter, announced that he was organizing a new corporation. He made a contract in the name of the corporation prior to its incorporation by which the corporation agreed to purchase merchandise from Russell. After the corporation was duly organized, Colley was unable to convince its directors and officers that it should purchase this merchandise and the corporation refused to accept it when it was duly tendered. Can Russell recover damages from Colley, or from the corporation, or from both of them?

Examination in Accounting Theory and Practice

PART II

MAY 15, 1936, 1:30 P. M. TO 6:30 P. M.

Solve problems 1 to 6 and problem 7 or 8.

No. 1 (20 points):

You are requested by a brewery to recommend the proper procedure of accounting for its kegs. The following information is supplied:

(a) Kegs are purchased and remain the property of the brewery.

(b) A charge of $5 (the approximate cost) is made to the customer for each keg containing the beer sold, with the privilege of returning the empty keg and receiving $5 credit.

All kegs are ultimately returned by the customer.

(c) Kegs are periodically reconditioned by outsiders and will last twenty years.

(1) Describe, as you would in a system report, the accounts that should be kept, the regular charges and credits thereto and the means whereby the accounts can be made to furnish a proper accounting control of the kegs.
(2) Prepare the journal entries for the aforesaid charges and credits.
(3) How would you show the following items on the brewery's balance-sheet?
   (a) 28,000 kegs owned.
   (b) 10,000 kegs with customers.
   (c) 3,000 kegs in the warehouse and shipping room, filled with beer.
   (d) 15,000 kegs in the warehouse, new and returned by customers.

No. 2 (24 points):

Phoenix Smelting Company (Co. A) has agreed to purchase the minority interest in Phoenix Mining Co. (Co. B). Their balance-sheets show:

	(Co. A) Phoenix Smelting Co.		(Co. B) Phoenix Mining Co.
Assets:			
Tangible assets..........	$3,764,513		$2,264,718
Goodwill................	500,000		
91,000 shares of Co. B.....	1,270,000	5,373 shares Co. A	622,443
	$5,534,513		$2,887,161
Liabilities:			
Creditors................	367,423		133,675
Capital stock 40,000 shares	4,000,000	100,000 shares	2,500,000
Surplus.................	1,167,090		253,486
	$5,534,513		$2,887,161

The stock is to be acquired at asset value, but in the computation the goodwill of either company is not to be considered. How much should be paid to the minority stockholders per share of Company B? Do not carry your computation further than whole cents per share.

No. 3 (15 points):

A corporation owning a deposit of glass sand has a capital stock of $500,000 and a surplus of $67,500. Its fixed charges, interest, management expense, etc., amount to $43,000 a year. This amount is constant and not affected by the output.

The accounts show that it costs $3.60 a ton to operate the deposit. This amount includes depletion and all costs except the fixed charges mentioned above, but it does not include state and federal income taxes. The selling price is $6 a ton.

State taxes amount to 4½% of the income; the federal income tax is 13¾% and is not allowed as a deduction in computing the state tax.

How many tons a year must be sold in order that the corporation may make 7% on its investment (capital stock plus surplus)?

How many tons must be sold if the return is to be 8%?

In each case the return is to be computed after payment of the income taxes. Fractional parts of tons should be ignored.

No. 4 (15 points):

The members of a medical society are classified according to the number of years each one has been in practice. They pay admission fees and annual dues as follows:

Class	Years in practice	Admission fees	Annual dues
A.................	Over 25	$150	$100
B.................	10–25	75	50
C.................	Under 10	None	25

Dues are payable for the entire year, irrespective of the date on which membership becomes effective.

No refunds are made on account of resignations, expulsions, etc.

Members reinstated are required to pay a full year's dues as of the date of reinstatement but no admission fees.

Transfers to higher classes become effective as of the beginning of the year and involve no admission fees.

During the years 1933, 1934 and 1935 the following changes took place in the membership:

	1933			1934			1935		
	A	B	C	A	B	C	A	B	C
Balance at beginning of year	150	275	120	152	285	130	147	304	158
Add:									
Elections	5	14	39	2	12	63	3	7	138
Reinstatements	2	3	1	1	2	2		1	1
Transfers (per contra)	17	23		10	31		14	19	
	24	40	40	13	45	65	17	27	139
	174	315	160	165	330	195	164	331	297
Deduct:									
Deaths	9	3	2	13	2	1	11	5	2
Resignations	10	5	2	3	11	4	4	10	5
Expulsions	3	5	3	2	3	1	1	5	1
Transfers (per contra)		17	23		10	31		14	19
	22	30	30	18	26	37	16	34	27
Balance at end of year	152	285	130	147	304	158	148	297	270
		567			609			715	

In the three years the expenses respectively amounted to $39,621, $41,236 and $44,787. There are no outside sources of revenue.

Although the membership is increasing, the society finds it more and more difficult to balance its budget, and it is proposed to remedy this condition and provide the funds for increased activity by making the following changes in the members' fees and dues, viz.:

1. Class C members to pay $25 admission fees.
2. Class C members to pay $50 when they become class B members.
3. Class B members to pay $75 when they become class A members.
4. Class C dues to be increased to $40 and class B dues to $75 per annum.

From the foregoing data prepare:

(a) A statement showing income and expenses for each of the years 1933, 1934 and 1935.

(b) A statement of income and expenses for 1935 as they would have been if the proposed increases in fees and dues had become effective at the beginning of that year. It is understood that the increases had had no effect upon the changes in membership.

No. 5 (8 points):

The Q Company, with all its four subsidiaries A, B, C and D located abroad, requires a consolidated balance-sheet for a special purpose at a date other than the end of a fiscal period. The subsidiary companies' balance-sheets and profit-and-loss accounts of that date are available and it is found that the inter-company balances do not agree. All differences are traced however and are satisfactorily explained as follows:

On the books of Q Company—

A was charged with $516.79 for furniture.
C " " " 1,828.00 for machinery.

On the books of A—

B was charged with $2,083.16 for furniture.

On the books of B—

Q was charged with $10,021.02 for cash remitted.
C " " " 1,858.78 for merchandise.

On the books of C—

Q was charged with $2,020.00 for commission, but this was not allowed by Q Company.
A was credited with $520.50 for a cash sale from A's merchandise held on consignment by C. Of this amount 20% was profit.

On the books of D—

Q was credited with $600 for cash remitted to D by a Q company customer.
A was credited with $380 for a sale from A's merchandise held on consignment by D. Of this amount 25% was profit.

Time does not permit the adjustment of the books and for present purposes it is intended to make the required changes directly on the consolidated balance-sheet.

Prepare a summary of the increases and decreases under the several balance-sheet headings. Disregard foreign exchange.

No. 6 (12 points):

A, B, C and D are partners in the manufacturing and selling of a patent invented by D. A lent the partnership $50,000 as his contribution to the organization and took a note for the amount. B was an experienced machinist and furnished the use of his complete machine shop, valued at $50,000, for the manufacture of the article exclusively, together with expert supervision. C gave his services as sales manager to create and perfect the partnership's selling organization. D turned in his patent at an agreed value of $50,000 as his contribution to the partnership's capital. Each partner was to receive one fourth of the profits. The profits in the first year were $60,000; in the second year $80,000; in the third year $120,000. At the end of the third year the whole business was sold for $500,000 cash. A's note had been paid and the drawings had been: A, $50,000; B, $60,000; C, $50,000; D, $20,000.

Prepare a statement showing the proper disposition and division of all profits. No consideration need be given to anything not specifically mentioned in the problem. Give the reasons for your allocations to the individual partners.

No. 7 (6 points):

An amusement park, operating during the summer months only, sells tickets to the public, good for admission to its various concessions. The tickets are not redeemable in cash but at any time after purchase may be used for admission to the concession and are honored even in the following season.

In making an audit of this amusement park at the end of its season you find that several hundred dollars' worth of these tickets has not yet been turned in and is apparently outstanding in the hands of the public.

How would you show this condition on the balance-sheet of the company?

No. 8 (6 points):

A loan is made with the proviso that on each interest date a payment shall be made on account of principal equal in amount to the amount of interest then paid, this arrangement to continue until the principal is reduced to approximately one half of the original loan, when a new arrangement will be made.

(1) Show by formula the number of payments required under the first arrangement.

(2) How many payments would be required to pay off the entire loan under the first arrangement? Give formula.

The Federal Social Security Act

By George P. Auld

The federal social security act as approved August 14, 1935, embodies the most ambitious scheme of social insurance ever adopted by a democracy. It focuses with great distinctness the cleavage of opinion, recently grown so sharp, between the theory of laissez faire, or "rugged individualism," and that of collective responsibility; and the fact of its passage by overwhelming congressional majorities offers impressive evidence that the latter attitude is strongly entrenched in the public mind.

The act legislates on three major aspects of the problems of so-called economic security and creates a Social Security Board charged with duties of administration. With respect to two of the projects, it seems a fair assumption that the new law contemplates little of substance or method in the way of alleviation or prevention of social maladjustment and human suffering that has not come to be broadly acceptable today to every thinking American. The legislation in those fields embraces (1) provisions calculated to stimulate nation-wide legislation by the states creating unemployment reserves of moderate size, as a charge on industry, for the benefit of workers in occupations other than agricultural, domestic and certain others, and (2) authorizations for federal welfare grants to the states which will supplement and tend to encourage state appropriations for financial assistance to the needy aged, for the blind, for dependent children and for general health services.

In a third field, the act provides for a national system of old-age retirement insurance, whereby national reserves as a basis for the payment of annuities after age 65 will be created from equal contributions by employees in occupations other than agricultural, domestic and certain others, and by their employers. This scheme has aroused controversy which seems likely to increase in intensity as the implications of the plan become clearer and its full impact begins to be felt.

From the viewpoint either of employer or employee, there must be few who disbelieve in the desirability of industrial workers of advanced years being enabled to give way to younger persons without undue hardship. How best to promote this end is the question. There are those who, knowing that security is a mirage, are opposed in principle to establishing a comprehensive system of governmental aid, which in their view will only foster an illusion, tend to destroy individual initiative and increase dependency and, perhaps, eventually create worse ills than those now requiring treatment. They believe the family to be the proper unit for determining and providing necessary aid to the superannuated worker, and that any national system of aid other than to the destitute and friendless will be so vast and will lead to such abuses as to fall of its own weight. They believe, moreover, that industry, out of whose product the population is supported, ought not to be burdened by the taxation necessary to finance such a scheme. These convictions are strongly held, and their strength is not diminished by a very human dislike for all taxes as such and an equally human tendency to believe that conditions not seen at close range or personally experienced can not be as bad as represented.

Of another school, though still outside the ranks of the millions of beneficiaries of the new legislation, there exists a substantial middle-of-the-road opinion convinced or disposed to believe that the conditions resulting from man's failure to control the business cycle are such as to demonstrate the gross inadequacy of any system of old-age protection not nationally organized. Persons of that persuasion believe that collective action in some form is necessary and practicable and that in these days of world-wide strain on the institutions of capitalistic democracy such action is dictated by the highest considerations of political expediency. Those who hold such views do not quarrel with the aims of the present act. Nor are they rightly to be charged with paying mere lip service to those aims when they express the view, as many do, that the financial mechanism of the present scheme is so badly devised as to make the plan a serious menace to our fiscal system.

The financial structure of the retirement plan is based on a principle involving the accumulation, incredible though it may seem, of forty-seven billion dollars of reserves intended to be carried over to the next generation. This principle, in the view of most financial authorities, renders the scheme as a whole unduly burdensome, unwieldy and dangerous. Due to the complexity and obscurity of the subject, there are few who appreciate that this conclusion coincides with the judgment of the president's committee on economic security, a distinguished body of high-minded and competent persons who were brought together in 1934 for the purpose of studying the subject and drafting suitable legislation. The plan that they formulated, after extensive consideration, including investigation of the British and other existing systems, never reached the floor of congress. Abruptly substituted for it in the ways and means committee, on the recommendation of the secretary of the treasury, and ultimately enacted into law, was a scheme that the president's committee had rejected. The difference between the two plans was not primarily or in important degree one affecting the scale of benefits to be paid. It was a difference in fiscal theory. The scheme adopted represented an attempt to make the plan theoretically "self-supporting," by application of an actuarial principle which in the opinion of the president's committee and its actuarial and financial experts was inappropriate and dangerous. The committee and its experts were convinced that reserves should be kept "within manageable limits" and that each generation should pay its own costs.

The task of putting the plan on a proper basis in this respect may conceivably prove more difficult as a matter of amendment than it would have been in the first instance. Popular forces supporting the principles of social insurance will be suspicious of change, and political racketeers will play upon their suspicions. Proponents of rugged individualism may make the mistake of regarding a movement for amendment of the plan as offering an opportunity for its emasculation. Nothing could be further from a realistic attitude, for, unless all signs fail, the people intend that a system of social insurance in one form or another shall operate in this country. Persons competent in finance and men of affairs generally will have the choice of adopting a constructive or a destructive attitude. If they choose the latter, the difficulties of reconciling conflicting views of political expediency and economic practicality may well place our institutions under a critical strain. The British democracy, in connection with this problem of social legislation, has successfully met such a test, for the Englishman, in addition to being able to think straight on public finance, is politically a highly astute person, instinctively aware or persuaded by long experience that judicious compromise is the foundation of all social order.

I. Federal-State System of Unemployment Reserves and Compensation

A federal-state system of unemployment reserves and compensation is established by the social security act, whereby reserves accumulated under state tax and compensation laws will be deposited in the federal treasury to be available for payments to wage-earners who lose their jobs. Eligibility and other details of administration of benefits will be governed by the respective state laws, subject only to approval of the state scheme by the Social Security Board as conforming to certain minimum standards, including a prohibition of payments to beneficiaries sooner than two years after the first contributions are made. Under the theory and practice of unemployment-compensation laws, the benefits do not apply to unemployed persons unless they have previously while in employment been covered under the plan for a stated time.

In order to induce nation-wide enactment of state unemployment compensation laws, the act under a separate title provides for a federal tax, against which credits may be taken for state taxes paid under state unemployment compensation plans, in a manner similar to the scheme in effect since 1926 under the federal estate-tax provisions of the revenue act. The new federal tax is provided by the assessment on each employer of eight or more workers, in all occupations not exempted, of a payroll tax of 1% in 1936, 2% in 1937 and 3% annually thereafter. If a state now has or later sets up an approved unemployment-compensation plan, an amount equivalent to the state tax paid by the employer is deductible from his federal tax, up to 90% of the latter; the remainder of the federal tax will be paid by the employer into the federal treasury.

The coverage contemplated by the federal tax provisions embraces workers performing service in the United States for employers of eight or more employees, in occupations other than agricultural labor, domestic service, service in the merchant marine, service in the employ of son, daughter or spouse or by a child under twenty-one in employ of parent, service in public employment (federal, state or local) and service in non-profit institutions operated exclusively for religious, charitable, scientific, literary or educational purposes or for prevention of cruelty to children or animals. The federal tax is assessable only on employers who on each of some twenty days of the calendar year, each day being in a different calendar week, had a total of eight or more employees. Such an employer is liable for the tax on total annual pay-rolls of employees of the included classes.

The scope of the coverage in the various state plans will be as wide as the legislatures of the respective states may determine.

The tendency in the states, however, will be to restrict coverage to the classes enumerated in the federal act as the basis for the federal pay-roll tax, since any state burden imposed on the employer in excess of 90% of the federal tax will operate to increase his total burden.

Under this scheme, the minimum total taxes payable after 1937 by an employer to his state government and the federal government together will be 3%, except that in so-called "merit rating" cases where under a state law the employer has qualified for a reduction in tax by reason of having fulfilled certain standards of regular employment, an equivalent amount may be deducted from his federal tax as an "additional credit," under the same conditions as if he had actually paid the normal state tax. The maximum of all taxes for unemployment insurance payable by any employer will be 3% in cases where the maximum rate under his state law is 2.7%. Wherever the state tax exceeds 2.7%, the maximum total burden on the employer will be increased over 3% by the amount of the excess.

The probable aggregate tax levies (state and federal) in connection with unemployment insurance, on the basis of 1929 data, and assuming uniform state tax rates of 3% on industrial payrolls, have been estimated by the National Industrial Conference Board at between $940,000,000 and $965,000,000 a year.

The unemployment reserves which will be built up by these contributions, separate for each state, are to be invested by the treasury only in interest-bearing direct or guaranteed obligations of the United States, acquired on original issue at par or in the market, and the government may issue to the fund special nonnegotiable obligations bearing interest at the average rate being paid by the United States government upon all its interest-bearing obligations. When required by the states to be used for compensation payments, the reserves are to be liquidated to the extent necessary to meet the requisitions, within the limits of the funds standing to the credit of the respective states.

As to the unemployment benefits that can be paid, the actuarial consultants of the president's committee on economic security, upon whose investigations the legislation was based, estimated that a nation-wide system of state plans levying pay-roll taxes at a uniform rate of 3% would yield enough to pay unemployed workers, on the basis of incomplete unemployment statistics during the period 1922–1933, an average benefit, after a four-weeks waiting period, of half-pay, with a weekly maximum of $15, for about 12 weeks.* After that the unemployed would earn the right to compensation again only after finding reemployment and continuing in employment for a qualifying period.

State costs of administration of unemployment compensation are to be met by the federal government, subject to approval of the state system of administration by the Social Security Board.

Compulsory unemployment insurance plans have been in effect in England and in ten other countries for some years, the British plan dating in its original form from 1911. These plans cover about 48,000,000 workers, a figure which also includes workers covered in eleven countries having voluntary systems. All European systems provide for nation-wide or state-wide "pooled reserves" and the contributions to the reserves are in all cases paid either (1) by the employers, (2) by employers and employees or (3) by employers, employees and the government. The contributions are everywhere expressed as percentages of pay-roll, except in England, Canada and Irish Free State where they are fixed at uniform amounts per employee.

In the United States a number of voluntary systems established by employers have existed for some years, but up to 1934 only one compulsory unemployment-insurance plan had been created —that of Wisconsin, which took effect July 1, 1934. Under the Wisconsin plan, reserves separate for each plant or industry were established. By the end of 1935 ten states had passed laws, of which Wisconsin and Utah had employer-reserve funds; pooled state funds are provided by New York, Alabama, California, District of Columbia, Massachusetts, New Hampshire, Oregon and Washington. Contributions by employees as well as employers are required by five of the states, Alabama, California, Massachusetts, New Hampshire and Washington; only in the District of Columbia are state (i.e. district) contributions provided (employees not contributing).†

The unemployment-compensation provisions of the act seek to induce, by the tax-offset device, nation-wide adoption of state unemployment-insurance laws. Before the passage of the act, the adoption of such laws was blocked as a practical matter by the competitive disadvantage in production costs which would have

* Revised estimates, per O. C. Richter (of American Telephone & Telegraph Co.) and W. R. Williamson (of Travelers Insurance Company) (two of the committee's consultants) in *Transactions Actuarial Society of America*, October, 1935, p. 331.

† W. J. Cohen, in *Social Security*, National Municipal League, New York, 1936.

been laid on employers in states enacting the necessary legislation without benefit of nation-wide application of the system. The situation is now radically changed. The federal tax runs everywhere, and the total burden on employers in states with compensation laws tends to be equalized by the federal tax credit device, and in states levying a tax no greater than 2.7% will be equalized, at the level of the burden on employers in states without compensation laws, where the federal tax must be paid in full. The adoption of state legislation thus becomes expedient in order that the contributions in any event to be made by employers may be used within the state for unemployment compensation instead of being paid into the general funds of the federal treasury.

The unemployment-compensation scheme has been described as an attempt to provide first-line defense against the direct social ravages of depressions. It is curious that criticisms of the new plan seem to be less prevalent among those inclined to the laissez-faire school of social thought than among the supporters of compulsory insurance, who might have been expected to give the scheme whole-hearted approbation. The truth is, however, that academic authorities and social workers, generally favorable to compulsory insurance, differ sharply among themselves as to the relative merits of various types of plans.

These divergencies of expert opinion, partly theoretical and partly based on studies of differing foreign practices, relate to matters such as type of reserves, source of contributions, employment eligibility qualifications and extent of waiting periods before compensation begins to run. Differences on these points were in large part responsible for the abandonment of any idea of setting up under the act either a uniform national plan or rigid detailed specifications for state plans under the federal-state coöperative scheme actually adopted. In face of disagreements over details, the president's committee believed that the time had come for "demonstration, not further debate and research." Its recommendation, to which Congress gave effect, was that latitude be allowed the states for the working out of plans of various types, in order that their respective merits might be studied at close hand in actual operation. This recommendation, moreover, as well as the separation of the taxing provisions from the regulatory provisions of the act, was actuated by a desire to bring the legislation within constitutional limitations as such might be interpreted by the United States Supreme Court.

The federal control effected under the act is derived from and restricted to the power of the Social Security Board to deny the tax credit to employers in states whose plans fail to meet the following general specifications, intended as "minimum standards of security and fairness": *

All compensation is to be paid through public employment offices in the state or such other agencies as the board may approve, and no compensation is to be payable until after two years after contributions first required.

State unemployment funds are to be deposited with the unemployment trust fund of the United States treasury, and the money when withdrawn is to be used solely for unemployment compensation, exclusive of administrative expenses.

Compensation is not to be denied any eligible person for refusal to accept work if (a) the position is vacant due directly to a strike, lockout or labor dispute, (b) the wages, hours, or conditions of work are substantially less favorable to the worker than those prevailing in the locality, or (c) if the worker would be required to join a company union or to resign from or refrain from joining a bona-fide labor organization.

The state must retain the right to repeal or amend its law.

Estimates already quoted indicate that the contributions to the reserves may ultimately amount to about $1,000,000,000 a year. It is estimated that the maximum reserves to be accumulated may be $3,000,000,000 or $4,000,000,000.† How significant the measure of relief effected by payments from such reserves will be is of course problematical. In depression times they will meet only a fraction of the problem. Whatever their significance relatively to the magnitude of future unemployment, however, it seems evident that a valuable partial solution of the problem will result from systematic action under definite specifications governing methods of contribution, standards of eligibility and amounts of compensation. It will be a great gain to have one substantial segment of emergency relief expenditures operated under a controlled system, freed from the difficulties and abuses inherent in the administration of relief expenditures made from general appropriations as now provided.

The unemployment reserves to be built up in the treasury and the balances which will normally stand in the reserve accounts will be of far less magnitude than those contemplated by the old-age retirement plan. By the criterion of size alone the task of

* *Report to the President of the Committee on Economic Security*, January 15, 1935, Government Printing Office, p. 16.
† O. C. Richter and W. R. Williamson, op. cit., p. 339.

their investment and management should therefore be a simpler one, but, as the president's committee recognized, the fluctuations which will occur in the size of the unemployment reserves will present special problems. In good times, the contributions to the reserves are expected to exceed the disbursements, but when serious depression sets in, the reserves will be depleted. With the onset of the depression, therefore, the securities in which the reserves are invested will have to be turned into cash, with attendant intensification of the deflationary movement.

Such a stimulus to the deflationary movement would be likely to occur, the committee pointed out, if the reserves were held by the states or in private hands. Under the national plan, however, it was the committee's view that this may be avoided, since the reserves would be so handled as to be coördinated with the credit policy of the government. The ways and means committee suggested that the treasury would not have to dispose of the securities in the market but could "assume them itself." * But if securities are thus to be kept off the market it can of course be done only by provision of cash by the treasury. If cash were raised by taxation a deflationary movement would still be set up, though presumably of less violence than one fostered by large sales of securities. If, on the other hand, the treasury were to raise the cash by borrowing, it is hard to see why the transaction would not in essence amount to selling the government securities taken over from the reserve fund. The treasury might of course sell the securities to the federal reserve system but as the latter has in any event the power to buy government obligations on the market, no very important advantage would appear to be gained by direct purchase from the treasury.

All in all, it seems illusory to expect that the operation of turning investments into cash for necessary emergency expenditures can be transmuted by the treasury into a beneficent reflationary process. It is the expenditure of the cash by the beneficiaries for consumption that should tend to neutralize the deflationary effects of selling securities. If, as a further reflationary measure, the federal reserve system should purchase securities in the market of like or unlike amount, such action would constitute a monetary or general credit operation not essentially related to the management of the unemployment reserves.

In boom times, on the other hand, it is argued that the treasury

* 74th Congress, 1st session, House Report 615, p. 9.

could put a brake on credit expansion by issuing non-negotiable securities to the fund and immobilizing the proceeds by keeping it on deposit in the federal reserve system. This appears possible. In that event it may be noted that the treasury would have to subsidize the fund from general revenues in an amount equivalent to the annual interest return required to be earned by the fund. Whether it is wise that the treasury should possess the power of intervening in monetary management by use of the unemployment reserves is perhaps a somewhat academic question, since in any event the ultimate control of the credit system of the country rests with the government. However, it would appear wise that the powers of the treasury in connection with the manipulation of the reserve funds be at least more clearly defined than is the case at present.

II. Federal Welfare Grants to States for Aged Needy and Other Purposes

The problem of the aged needy, or of poor-relief, so-called since Elizabethan days, has always pressed on the local communities. Its administration has been inadequate and in many communities inhuman and indecent. The old local poorhouse basis of relief is no longer, however, in good odor, and at the end of 1935 state pension plans, the adoption of some of which had been stimulated by the passage of the social security act, were in effect in thirty-nine states.* Population trends are making the problem progressively more burdensome. Due to a declining birth rate and the restriction of immigration, the proportion of elderly people in our population is steadily increasing. There are now approximately 7,500,000 people in the country who are over 65 years of age. It has been estimated that by 1970 the number will be 15,000,000, by 1980 17,000,000 and by the end of the century about 19,000,000. Instead of 5.4 per cent. of the population who were in this age group in 1930, it is estimated that there will be 10.1 per cent. in 1970, 11.3 in 1980 and 12.7 per cent. in the year 2000.

In connection mainly with this problem the social security act sets up a system of federal welfare grants embracing authorizations for the annual appropriation of grants to the states from the general revenues of the national government. Under these

* Eveline M. Burns, *Toward Social Security*, McGraw-Hill Book Company, New York, 1936, p. 46.

authorizations, the United States undertakes to match, on an equal basis, the state's appropriations for financial assistance to "aged needy individuals" (thus excluding persons covered by the retirement-insurance plan except as their annuities may be too small to live on) up to a maximum federal contribution to any person of $15 a month, plus 5% for administration costs. State plans, to be approved, must be mandatory in all political subdivisions.

The annual cost to the federal government of these old-age relief grants by 1980 was estimated by the actuaries of the president's committee at about $700,000,000, assuming the existence of a contributory system substantially equivalent to the retirement insurance plan enacted in the social security act.* The actuaries assumed a gradual increase in dependency ratio to one in 1980 of 50% of all persons over 65, or over 8,000,000 dependents, before deductions for those to be cared for by the retirement plan. The estimates were further made on the basis of an average relief payment of $25 monthly of which half (plus costs of administration), would be borne by the federal government, and on the basis of approximately 4,600,000 aged needy, after deducting those able to live on the annuities provided by the retirement plan. The president's committee considered the actuaries' figures to be based on excessive estimates of the dependency ratio and average benefits. They placed the cost on a comparable basis at $300,000,000 annually. Recent reports of Canadian old-age dependency ratios appear to support the estimate of 50% made by the actuaries.

O. C. Richter and W. R. Williamson, who participated in this work say:

". . . it is evident that the state and federal governments are faced with large expenditures in future years for the relief of the needy aged. The increase . . . can not properly be attributed, however, solely to the passage of the act. It is mainly due to the inevitable increase in the number and proportion of the aged in our population. The relief problem in respect of this group would need to be met in some fashion, regardless of whether or not the social security act or similar legislation were adopted."†

* O. C. Richter and W. R. Williamson, op. cit., p. 307. An apparent obscurity in the text of their paper as to the scope of the retirement plan which was excluded in making the cost estimate of $700,000,000 for old-age relief grants is cleared up by the above phrase "substantially equivalent to the retirement insurance plan enacted," etc., added by the writer on oral information supplied by one of the joint authors. Assuming no contributory system, the actuaries estimated the federal half of the annual costs by 1980 at $1,300,000,000 for old-age relief to over 8,000,000 persons.

† Op. cit., p. 307.

The act also provides for grants to the states for the blind, on a fifty-fifty basis, with the same maximum on individual benefits, as well as grants, up to certain maximums, for crippled or otherwise dependent children and for child welfare, maternal care and health services in general. The annual cost to the federal government of such grants is estimated at $75,000,000.*

III. National Old-Age Retirement Insurance

A single system of contributory old-age retirement insurance ("federal old-age benefits") is created by the act for the benefit of persons in occupations not exempted, the annuities thereunder to be paid monthly to any person retired from employment who is at least 65 years old and who will have earned not less than $2,000 total wages after December 31, 1936 and before attaining the age of 65, and who will have received wages on some day in each of any five calendar years after December 31, 1936 and before attaining age 65. Insurable service must be performed within the United States.

Under the plan, annuities will be payable, beginning in 1942, from reserves to be accumulated from 1937 from a federal payroll tax annually assessed on all employers of persons of eligible classes and an equivalent special federal income tax annually assessed on the wages of the employees, the latter tax to be collected by the employers. Each of these two taxes starts at 1% in 1937, and rises ½% at three year intervals to a maximum of 3% in 1949 and thereafter; neither tax is applicable to that portion of an individual's wage or salary which exceeds $3,000 annually or to wages or salaries of persons over 65.

It has been estimated on the basis of the 1930 census that about 26,000,000 persons, or 53% of the gainfully employed population, will be covered by the old-age retirement provision. The retirement scheme excludes workers not only of occupations excluded under the unemployment compensation scheme (i. e., agricultural, domestic, marine, governmental and non-profit institutions) but also casual labor not in the course of the employer's trade or business and also service in employ of a carrier as defined in the railroad retirement act of 1935. The coverage does not exclude one class excluded under the unemployment compensation provisions, viz., service in the employ of son, daugh-

* Based on estimate used by Eric A. Camman of $150,000,000 for total federal and state costs, The Journal of Accountancy, April, 1936.

ter or spouse or by a child under twenty-one in employ of parent. Self-employed persons are excluded.*

The annuities payable to beneficiaries are to range from a minimum of $10 a month to a maximum of $85 a month, determined, within these limits, as percentages of total earnings (including only that portion in any one case not exceeding $3,000 annually) from January 1, 1937, to date of attaining age 65. The percentages prescribed are ½ of 1% monthly on total earnings from $2,000 to $3,000, 1/12 of 1% on the next $42,000, and 1/24 of 1% on the next $84,000. Stated another way, the monthly benefit will be $5 on each $1,000 of the first $3,000 of insured earnings; $5 for each $6,000 of the next $42,000 and $5 for each $12,000 of the next $84,000.

It will be noted that by the operation of this formula, the maximum benefit of $85 a month or $1,020 a year will be received by a retired worker who will have earned $3,000 (or more) a year for 43 years after 1936, or a total of $129,000 insurable earnings by 1980. His contributions during that period will have amounted to $3,420 (or $450 less than the amount computed at the maximum rate of 3% taking effect in 1949) and those of his employer to an equal sum. In case of death of a contributor either before or after retirement, his estate will be entitled to receive 3½% † of the base total earnings, less the amounts of any annuities received by him. A similar payment of 3½% of earnings will be made to any living contributor who upon attaining the age of 65 is not entitled to receive annuities.‡

The total tax revenue by 1949 under the old-age retirement plan, computed at the maximum combined rate of six per cent. which becomes effective in 1949, has been estimated by the National Industrial Conference Board at from $1,700,000,000 to $1,850,000,000 annually, half payable by employers and half by employees. The annual costs of the plan and the revenues for its support rise gradually during the preliminary period between

* Under the so-called Clark amendment offered in the Senate but laid over for subsequent attempt at agreement by the 1936 session of Congress, employers operating private pension plans and their employees would have been exempted from the national system. The arguments that prevailed against its adoption were largely based on the probability that it would result in adverse age selection against the public plan due to a preference of employers of relatively young workers to elect to operate under a private plan. This and other considerations are discussed in *Social Security in the United States*, by Paul H. Douglas, McGraw-Hill Book Company, New York, 1936.

† I. e., ½% in excess of his contributions if computed at the maximum rate of 3% and something more than ½% for all entrants from 1937 to 1949.

‡ Among those covered by this provision will be all those who attain the age of 65 (a) not having earned a total of $2,000 insurable earnings after 1936 or (b) not having been insurably employed on one day of each of five calendar years after 1936 (which would automatically include all persons whose 65th birthday falls on January 1, 1941, or before).

1937 and 1980.* During that period income will keep substantially ahead of costs, the purpose being to build up the reserve. Only a relatively small part of the reserve would be required as a provision against current fluctuations in revenues, the bulk of it being created for the sole purpose of providing an interest-earning fund. The Senate committee on finance † estimated that shortly after 1965 the tax revenues then coming in at the rate of $2,000,000,000 a year will be exceeded by the benefit payments, so that the interest accumulations on the reserve will then for the first time be called on. In 1980 the tax revenue will reach its normal maximum at $2,180,000,000.‡ At that time the maximum individual earnings of $129,000 spread over 43 years will have accrued as a base for benefits, and the maximum normal payments from that year onward were estimated at $3,500,000,000 annually. By that year the reserve, with interest accumulations at 3% added and after deducting benefits paid in the meantime, will amount to $47,000,000,000.

On similar estimates, the secretary of the treasury maintained that the plan from 1980 onward will be "self-sustaining," § the aggregate annual benefits being provided 60% by annual contributions of approximately $2,100,000,000 and 40% by interest earnings of approximately $1,400,000,000 on the reserve funds. These estimates were based on an assumption that the average worker will not in fact retire from gainful employment and thus become eligible to benefits before the age of 67½ years. The uncertainty of this assumption || together with the uncertainty of other factors tends to cast doubt in the minds of actuaries on the validity of the estimates. If workers were in fact to retire by 65, the annual requirements of the plan would be increased by an estimated amount of $1,160,000,000,¶ which would have to be provided from general revenues of the government. Another apparently serious defect in the asserted self-supporting character of the plan arises from the item of interest earnings on the reserve, which will be discussed later.

Since benefits are computed on a scale of percentages of total

* Only minor costs will be incurred in the first five years, arising out repayments of contributions to estates of contributors dying before 1942 or repayments to living contributors who do not qualify.

† 74th congress, 1st session, Senate Report No. 628.

‡ However, M. A. Linton, president, Provident Life Insurance Company, one of the advisors to the president's committee, states that the plan could ultimately be carried by a tax of less than 6%.—*Transactions Actuarial Society of America*, October, 1935.

§ Committee on ways and means hearings—H. R. 4120, 74th Congress, 1st session, p. 905.

|| M. A. Linton, *op. cit.*, p. 369.

¶ Eveline M. Burns, *American Economic Review*, March, 1936, p. 15.

wages earned, which decreases as the amount of total wages rises, it is apparent that the annuities, relatively to earnings and contributions paid, favor workers in the lower income brackets and also favor persons entering the plan at advanced ages, who will consequently become entitled to annuities after relatively short periods of making earnings and paying contributions.

The relatively higher annuities to lower paid workers on equal service are illustrated below by comparison of case 1 with case 2, case 3 with case 4, etc., and the more favorable treatment for shorter service at equal monthly earnings is illustrated by comparison of case 1 with cases 3 and 5, and case 2 with cases 4 and 6 (full employment from 1937 to age 65 being assumed in all cases):

Cases entering in 1937	Years before age 65	Average monthly wage for period	Retirement annuity, monthly amount	*Total contributions	Annual amount of annuity as percentage of contributions
1	40	200	71.25	5,040	17%
2	40	100	51.25	2,520	24.4%
3	20	200	51.25	2,160	28.5%
4	20	100	32.50	1,080	36.1%
5	10	200	32.50	768	50.8%
6	10	100	22.50	384	70.3%

* ½ by employer, ½ by employee, at actual rates from 1937.

The figures in the final column above indicate the differential favoring the lower earners and the shorter-period participants. Equivalent differentials appear if contributions are compounded annually at 3% for the respective periods to show the reserves accumulated at the end of the periods, from which the annuities will be paid. Taking the contributions uniformly at the maximum rate of 6% on wages, the following reserve and annuity data appear:

Case	Period in years	Average monthly wage	Reserve at age 65	Annual amount of annuity as percentage of reserve	No. of years reserve (a) will pay annuity	Years of life expectancy at 65 unprovided for by *half of reserve	Years of life expectancy at 65 unprovided for by total reserve
1	40	200	10,858	7.9%	16	5	†
2	40	100	5,429	11.3%	10	7	2
3	20	200	3,869	15.9%	7	9	5
4	20	100	1,935	20.2%	5	9+	7
5	10	200	1,651	23.6%	4	10	8
6	10	100	825	32.7%	3	10+	9

(a) With interim interest accumulations.

* Indicating excess expectancy at 65 over anticipated exhaustion of half of reserve created by employee's own contributions.

† Overprovided four years.

Since the expectancy of life at 65 is approximately 12 years, the final column above indicates that the annuities of persons like cases 2 to 6 will in part be paid from reserves accumulated for persons like case 1.

Millions of persons of advanced ages will enter the plan in 1937, and such persons, though in much smaller numbers, will continually be entering in future years when they first take up employment in an insured industry. The relatively more favorable treatment which these contributors will receive constitutes the so-called "unearned annuities" of the plan. These unearned annuities will be carried by the disproportionately high contributions made by and for participants entering at early ages. Even so, the benefits to participants entering at advanced ages are extremely small. It is expected that supplementary allowances will be made to such persons under state legislation for assistance to the needy aged and, as already indicated, provisions of that sort were included in the actuaries' estimates of ultimate annual costs of the non-contributory old-age relief system.

The problem of "unearned annuities" confronts every pension scheme at its inception. It has been pointed out by M. A. Linton who served as consulting actuary to the president's committee, that the British plan, which was established in 1926 and includes some 17,000,000 contributors, operates upon a different theory from ours. It provided that maximum benefits should be paid at the outset. The older workers in the insured occupations "were not to be penalized because a system had not previously existed to which they could have contributed." Under our plan the annuities relating to a given scale of earnings increase over the period of time from 1937 to the date of reaching age 65, and the full benefits will not be enjoyed for many years to come. "To a much greater extent than in Great Britain," says Mr. Linton, "we have postponed the adequate treatment of the problem presented by the accrued liabilities." *

Under the British system the "unearned annuities" are met by outright grants from the exchequer. The system is largely on a current-cost basis. This is British realistic fiscal policy. No attempt is made to build up reserves at the cost of denying the present generation benefits which have been determined as necessary and desirable and at the risk of dangling immense sums of ready cash before the eyes of pressure groups and electioneering politicians. The latter feature is the most disturbing part of the American plan.

* M. A. Linton, *op. cit.*

The contemplated creation of centralized reserves in liquid form mounting to the stupendous figure of $47,000,000,000, fantastic and unreal though it may seem, has been written into the law of the land. These funds will be under the control of Congress. In an effort to avoid constitutional difficulties, the act was so drafted that no direct connection is to be traced between the revenues to be raised under the taxation title and the creation under another title of the reserve account from which the benefits are to be paid. Under the act Congress is "authorized" to appropriate annually to the reserves amounts (nominally from general revenues) necessary to meet the requirements on an actuarial basis. But Congress retains the power to modify the appropriation requirements and thus to use for other purposes the enormous revenues which during the preliminary period will be rolling in for the purpose of building up an interest-bearing fund—a purpose which to practical politicians will seem highly theoretical. It is putting it mildly to say that the temptation for the diversion of these funds or alternatively for liberalizing the annuity benefits will be strong.

Moreover, even under present provisions, the funds appropriated to the reserves are required to be invested in government or government-guaranteed obligations. The billions pouring in in cash will thus be available not only for purchase of government securities outstanding in the market—a contemplated procedure which raises highly important but at present unanswerable questions as to the effect on the investment and money markets—but also for the purchase at par of newly created government obligations. Thus there is provided a great pool of funds available for extravagant government borrowing, which will lack any of the credit controls ordinarily exercised by the investment market.

Another curious and disquieting situation is created by the fact that government or government-guaranteed securities to the amount of $47,000,000,000 must theoretically be available for investment of the reserves, whereas the amount of such debt now is only approximately thirty-six billions, of which some 31½ billions are direct obligations of the government.

Various authorities * have pointed out the anomalies and dangers of this scheme from the standpoint of the integrity of the plan itself and of the government finances. As was mentioned

* Notably M. A. Linton in *Atlantic Monthly*, April, 1936.

at the outset, the provision for reserves of this magnitude was not the result of recommendations of the president's committee or of its consulting actuaries and financial experts. The committee's plan called for tax rates commencing at 1% and rising after 20 years to 5% (2½% on employer and 2½% on employee) which were estimated as sufficient to cover the disbursements for the first thirty years and in addition to accumulate a reserve of about $11,500,000,000, large enough to provide against current fluctuations in the revenues under the plan: after 1965, when disbursements would regularly exceed revenues, a federal subsidy from general taxation, rising to a maximum of $1,100,000,000 a year, would have been required.* The creation of such a reserve, it may be noted, was slightly in excess of a figure of $10,000,000,000, which in the opinion of advisors representing the treasury and the federal reserve system was the maximum which might be handled without too serious complications.

This scheme was abandoned by Congress on the plea of Secretary of the Treasury Morgenthau that the plan should be made "self-sustaining." It was desired to avoid the contemplated annual subsidy of $1,100,000,000 from general revenues, none of which as a matter of fact would have been required, under the estimates, before 1965. Under a non-reserve plan like the British plan, such a subsidy would be required earlier, but under the displaced plan of the president's committee, with its moderate tax and reserve provisions, income would still have exceeded outgo for the next thirty years.

Even so, the claim that the new plan is self-sustaining does not appear well-founded. Ignoring, for the present purpose, the possible deficit of $1,160,000,000 a year due to estimating average retirements at age 67½ instead of 65, it seems apparent that on the basis of the present estimates themselves and fiscal conditions as they are, a subsidy of $330,000,000 to $450,000,000 a year is contemplated by the present plan, and that this subsidy will be in effect increased by the amount of 3% a year on the face amount of all government debt now existing which may be retired over the next generation by a judicious policy of debt redemption suitable for a period of prosperity.

The reasons underlying this statement go back to the fact that

* Richter and Williamson, op. cit., p. 314, et seq. These figures were increased to $15,000,000,000 and $1,500,000,000, respectively, to include agricultural and domestic workers, who were later excluded because of practical difficulties of administering a plan covering such employments. (Casual labor was also omitted for the same reason.)

the supposed actuarial balance of the fund is predicated on annual interest earnings of $1,400,000,000 on a capital sum of $47,000,000,000 invested in government obligations. If the fund, however, were to absorb all of the $36,000,000,000 of such obligations, including government-guaranteed debt, now outstanding, an additional annual payment to it of $330,000,000 would be required as "interest" on the remaining $11,000,000,000 in the reserve. The information available for proper comprehension of the intent and meaning of these features of the plan is defective both as to clarity and completeness. It would seem absurd to assume that unnecessary governmental expenditures outside the scope of the plan would have to be incurred merely in order to create an additional $11,000,000,000 of government obligations for placement in the reserve fund on an interest-bearing basis. Such an assumption, however, appears necessary to support the claim that the plan is self-sustaining. Of course, if the government should in fact increase its deficit another $11,000,000,000, an annual payment to the fund of 3% on the new debt would properly be chargeable in the national budget as interest expense and not as a subsidy to the plan. But if, as everyone interested in security should devoutly hope, governmental deficits are to be brought under control, the creation of treasury obligations for issuance to the fund in exchange for $11,000,000,000 cash would amount to nothing more, from a fiscal point of view, than the delivery of warehouse receipts for cash to be kept in trust by the treasury and presumably immobilized in the federal reserve system. The subsequent receipt by the fund, from the treasury, of annual interest of $330,000,000 on the capital sum would be nothing, from the viewpoint of the budget, but a subsidy to the plan from general revenues.

In addition, it is to be noted that the unemployment reserves contemplated by the present act, which it has been estimated will amount to $3,000,000,000 to $4,000,000,000 before being paid out, have to be invested in government obligations. Either as a subsidy to the old-age retirement plan or to the unemployment-compensation plan, the provision of a return of 3% on these sums (while unexpended) added to the $11,000,000,000 excess investment funds already indicated, will be a charge on the federal budget. This brings the total subsidy for the two plans together to an amount ranging at times up to $450,000,000 a year, of which it would appear that $330,000,000 is definitely chargeable to the retirement plan and the remainder is subject to allocation on some basis to be determined. Without laboring the further point as to the subsidy arising in an annual amount equivalent to the interest on any government debt which may in the future be retired, it seems clear that the fund is far from being self-supporting under the present set-up, and that the incalculable dangers of massed reserves are to be hazarded without obtaining any compensating advantage even in theory.

From a practical standpoint, British experience and competent expert advice pointed to the desirability that the fund be operated partly on a current-cost basis. No fiscal advantage or actuarial necessity was seen in attempting to make it self-sustaining. It appeared wiser to have the benefits partly met out of current revenues, where their costs would be apparent, than to create a huge pool of funds, the existence of which would have unpredictable though doubtless far-reaching monetary and general economic effects and would jeopardize the integrity of the fiscal system during a period when with good management it might otherwise be reconstituted on a sound basis.

The suggestion has been made by Mr. Linton* that the most practicable way of avoiding the dangers of the reserve system of operation would be to permit the 2% total annual tax applicable to the years 1937 to 1939 to remain in effect indefinitely without making the triennial increases up to the 6% maximum contemplated by the act. He points out that on the basis of the estimates underlying the report of the Senate finance committee the 2% tax would annually produce more than enough to meet all benefit payments and expenses until 1951, and that the investment at 3% annually of the excess tax receipts prior to 1951 would by that year create a reserve of $6,000,000,000. By then using the principal of the reserve for payments the plan on the present basis of benefits could be financed for a further twelve years without raising revenue other than the 2% tax. A solution along these lines, which should, however, presumably contemplate the maintenance of a contingency reserve of moderate proportions, would appear desirable.

IV. General Considerations

The four chief fields of insecurity suitable for coverage in a broad program of social legislation have been classified by stu-

* *Atlantic Monthly*, April, 1936.

dents as unemployment, loss of a bread-winner, old age and sickness. The present act deals with the first three and to a minor extent with health services. It has been estimated that an adequate system of health insurance, such as was outlined by the president's committee, but not yet adopted, would require an additional tax of 6% on wages.

The direct money costs of the law as it stands, on the basis of estimates already discussed, may amount by 1980 to $4,500,000,-000 a year, as indicated below:

Unemployment reserves—	
Tax on employers, 3% on pay-rolls re certain occupations.	$1,000,000,000
Miscellaneous welfare grants (federal share—approximately half)	75,000,000
Assistance to needy aged (federal half)	700,000,000
Old-age retirement benefits—	
Tax on employers, 3% on pay-rolls re certain occupations; and tax on employees, 3% on income up to $3,000 a year	*2,180,000,000
Deficit in interest on retirement-reserve account (see page 448)	330,000,000
Administration (see hereafter)	225,000,000
Total (excluding state costs)	$4,510,000,000

* Represents that portion (60%) of estimated annual benefits payable which will be met by taxes (the remaining 40% being met by interest on the accumulated reserve). Estimate of benefits payable was based on assumption that average contributor will retire at 67½. If in fact he retires at 65, additional costs would have to be provided for (see page 443). Taxes cease when employee attains age 65; benefits do not begin until he retires.

Certain students have emphasized that the cost of the social security act, as the "first large-scale attempt to raise the funds for providing economic security in a more orderly and controllable manner," represents to a very large extent the "redistribution of an existing burden" and not new burdens on the productive elements of the community.* Such a generalization is subject to important qualifications. Certainly the burdens will not exceed the burdens of the depression through which we have been passing. But the costs of depression can hardly be taken as normal. To the extent that unemployment reserves created in good times will mitigate the burdens of the next depression, the costs of the act will not be added costs. Beyond that, the assertion that the costs represent largely a redistribution of existing burdens begs the chief question raised, viz., whether the act will itself

* Eveline M. Burns, *American Economic Review*, March, 1936.

encourage and create dependency. That question is unanswerable on the basis of observed facts having important statistical significance. It poses a riddle in social philosophy, to which the possible answers, being no more than dialectic expositions of individual theories of human behavior, are inconclusive. Only an expert of some as yet undiscovered science of social accounting could analyze the estimated costs of this legislation, as between new and merely redistributed burdens, or allocate the new burdens, such as they may be, between objects basically productive to society and those to be accounted for as waste.

Where the burden of the taxes on the employer will in fact fall is, of course, uncertain. In the opinion of Dr. Eveline M. Burns, the greater part of it will be shifted forward to consumers or backward to wage-earners. She further analyzes the question as follows:

> "The old-age annuities tax is perhaps more likely to fall on consumers and the unemployment compensation tax to fall on wage recipients. For the former makes no differentiation between competing employers. All must pay a uniform tax. But the unemployment compensation tax is less likely to be shifted on to consumers because of the competition of employers of less than eight workers (who are not covered by the tax), and also because a number of states intend to adopt the merit-rating system. Moreover, since workers know that employment in the excluded trades or with employers of seven or less workers involves a loss of unemployment benefits in the future, they may well be prepared to accept lower wages with larger employers."*

On the other hand, some have assumed that the employers' contributions will be in large part a charge against profits. If such an assumption, as a generality, is tenable, it may be said that the complete case for it has not yet been made, and the weight of economic opinion appears to be against it. It has also been urged, more convincingly, that industries whose product has a high labor content will be placed under a competitive disadvantage by the social-security taxes and that the resulting tendency in such industries will be toward increased mechanization and consequently increased technological unemployment.†

Such possible industry adjustments and the general question of the final incidence of the costs and their effect on purchasing

* In her article last cited.

† For a discussion of this subject and exposition of the thesis that our export trade will be placed under competitive disadvantages see *Your Securities under Social Security*, by Arundel Cotter and Thomas W. Phelps—Dow, Jones & Co., Inc., N. Y. 1936.

power are among the uncertainties of the program. Their potential importance would be substantially lessened by adoption of the proposal to abandon the high reserve scheme of the retirement plan and keep the taxes for its support at the 2% level. Such a policy, which, as has been noted, appears highly desirable for other important reasons, would eventually throw current-cost subsidies as a charge on the so-called "residual" system of old-age assistance, supported in part by general federal revenues and in part by state taxes. Whether this is a better solution from the standpoint of incidence of taxes is a question to which a satisfactory answer might be found during the fifteen years or more which would elapse before the problem would become a pressing one.

It has been asserted that the social-security taxes will be pyramided in costs, like a sales tax. Eric A. Camman has conclusively shown that this is not the case—that the tax on the labor content of the product will go into costs but once, no matter how many subsequent times the product may be processed. Mr. Camman has also competently outlined the problem of administration, which will present large but presumably not insuperable difficulties. In dealing with the subject of administration costs, he uses an estimate of $225,000,000 annually.*

The case for national action on the matters dealt with by the act is summarized by the president's committee on economic security, in its report, in part as follows:

"From the best estimates which are obtainable, it appears that in the years 1922 to 1929 there was an average unemployment of 8 per cent. among our industrial workers. In the best year of this period, the number of the unemployed averaged somewhat less than 1,500,000. . . . At least one-third of all our people, upon reaching old age, are dependent upon others for support. Less than 10 per cent. leave an estate upon death of sufficient size to be probated. There is insecurity in every stage of life. For the largest group, the people in middle years, who carry the burden of current production from which all must live, the hazards with which they are confronted threaten not only their own economic independence but the welfare of their dependents. . . . Many people lived in straitened circumstances at the height of prosperity; a considerable number live in chronic want. Throughout the twenties the number of people dependent upon private and public charity steadily increased. With the depression, the scant margin of safety of many others has disappeared."

* Op. cit.

Individual security is something hoped for but forever unattainable. Social security in the broad sense, however—in the sense of the continued stability of our institutions—may well be served in important degree by this act, when it has been suitably amended and after constitutional difficulties, if any, have been surmounted. Its value in this respect should come from an appreciation by those caught in the wheels of the machine age that a national responsibility toward them has been recognized.

Cost-Keeping for National Forests

By David Hartman

The United States Forest Service is developing a fund-cost-accounting system. Fund accounting has of necessity existed from the early days of the service. The cost-keeping element is of more recent origin; in fact it is now in process of development. It is the purpose of this article to give a brief picture of the system.

Entries to record funds are made in two registers. The allotment register is little more than a small ledger containing a dozen or more accounts, one for each fund or appropriation. As notification is received of an addition to or deduction from an appropriation, an entry is made directly in the ledger account, which, by the way, shows at all times the total of the appropriation to date by means of a balance column. The official notices of changes in appropriations are the supporting vouchers for all entries in the allotment register.

For every expenditure from an appropriation a voucher is prepared. Before this is submitted for payment, it is entered in the voucher register, which is like a cheque register for a firm doing business with a dozen banks and having a cheque column in its cheque register for each bank—in the present case a column for each appropriation. The total of any particular column gives the expenditures from that appropriation. The differences between the totals of the voucher register and the allotment register give the appropriation balances. The two books have some elements in common with a cash-receipts book and a cash-payments book.

But the lack of complexity of the fund bookkeeping is inversely proportional to the restrictions on the use of funds; and it is this which keeps a forest service accounting office on its toes. Funds, or appropriations, are designated for special purposes and can not be used otherwise. At present there are more than a dozen funds available for the use of the service; the number varies in the different regions. "Salaries and expenses" and "forest road development" are examples of what might be termed regular forest service appropriations. The former is set aside to meet the salaries of regular employees and all expenses incident to their work. "Forest road development," as the name suggests, is for the building of roads and trails on the national forest lands.

Besides the regular funds there are at present or have been in the recent past several special funds which have come to the service under the various relief appropriations made by congress. For instance, the work of the civilian conservation corps has required additional money. While the wages of the members of the C.C.C. are not paid by the forest service, yet C.C.C. men work for the forests and under the direction of forest service men. The service furnishes material, equipment and the necessary supervision. To meet such outlays additional appropriations have been provided. Part of the 1935 federal appropriation of over four billions came to the forest service for the employment of men who were on the relief rolls. These men were used on all types of maintenance and construction work in the forests. Ranger stations have been built, telephone lines constructed, firebreaks made and varied other improvements brought about.

The regulations governing all these funds, both regular and special, are numerous and rigid. Each forest service regional office has a regional fiscal agent, whose duty it is to review all vouchers submitted for payment by the various forests in his district. Of course, payment of vouchers is not made by the accounting offices of the forests; vouchers, including salaries and wages, are paid by cheque from the regional offices.

As an example of a common task in fund disbursement, let us suppose that an employee of the engineer's office of a forest is out on a truck trail-locating job. His salary would properly be chargeable to a road fund, forest road development, for instance. But let a forest fire start near the truck trail-locator's vicinity and he will be summoned by the forest fire chief for fire duty. Spending road money for fighting fires is taboo. So our truck trail-locator's salary for, say sixteen hours, must come out of "fighting forest fires," a subappropriation of salaries and expenses. Many similar problems in disbursements faced by the accounting office of a local forest and the regional fiscal agent could be cited.

As previously stated, the cost part of the accounting is of recent origin. In fact, it is still in flux. A manual, *Cost Accounting*, was published not so long ago and has already been revised and supplemented several times. Plans for further revision and simplification are under way. The system is built around the resources of the forest. By resources is to be understood, not assets in a balance-sheet sense, but things in the national forests which yield a benefit to the public whether the benefit be of a commercial nature, such as grazing, or recreational, as fishing, camping, sightseeing, etc. It is not possible to state the value of the forest "resources" in dollars. Some of the values are monetary, but obviously there are others upon which no monetary value can be placed. At present the resources are divided into six classes: (1) timber, (2) grazing, (3) water, (4) recreation, (5) fish and game and (6) land.

In theory all expenditures have to do with these resources. Some expenditures apply to a particular resource; others apply to more than one. At present the classification of the expenditures, or "activities," as the cost accounting classification designates its accounts, is not complete. Some of the activities overlap as far as their relation to the resources are concerned. As the system is worked out in use, further classifying of the cost accounts in their relation to resources will take place. Activities may be expense accounts, investment accounts—that is, assets—or of an unclassified nature, somewhat like deferred items and organization expense found in the commercial world. This lack of classification as between expense and asset is, likewise, due to the experimental state of the system.

The activity expenditure accounts are—

A. Indirect accounts
- 1. General overhead (If a charge does not belong to any particular activity or activities, the entry is made to activity No. 1, general overhead. At the end of the fiscal period, the total of this account is prorated over the other activities.)

B. Expense accounts (The reader will be less mystified if he supplies the word "expense" after some of the accounts in Group B.)
- 2. Timber sales
- 3. Forest products sales
- 4. Timber, non-revenue
- 5. Grazing, C&H, revenue
- 6. Grazing, S&G, revenue
- 7. Grazing, non-revenue
- 8. Fish and game, revenue
- 9. Fish and game, non-revenue
- 10. Uses, revenue
- 11. Uses, non-revenue
- 12. Recreation, non-revenue
- 13. Water, non-revenue
- 14. Land adjustments
- 15. Maintenance roads, forest development
- 16. Maintenance trails
- 17. Maintenance roads, forest highways
- 18. Maintenance headquarters improvements
- 19.1. Maintenance other improvements, structural
- 19.2. Maintenance other improvements, roads and trails
- 19.3. Maintenance other improvements, non-structural

C. Investment accounts
- 20. Roads and trails, forest development

21. Roads, forest highways
22. Headquarters improvements
23.1. Other improvements, structural
23.2. Other improvements, roads and trails
23.3. Other improvements, nonstructural
24. Acquisition, exchange and gift
25. Acquisition, purchase
26.1. Reforestation, field planting and seeding
26.2. Reforestation, other
27. Nurseries
28. Timber surveys and plans
29. Grazing surveys and plans
30. Fish and game surveys and plans
31. Recreation surveys and plans
32.1. General surveys and plans
32.2. Other investments
33. Timber stand improvement
34. Road and trail equipment
35. Fire equipment
36. General equipment
37.1. Stores
37.2. Stores, roads and trails

D. Protection accounts

38. Fire prevention
39. Presuppression
40. Fire suppression
41. Insect control and other timber protection

E. Coöperation and miscellaneous accounts

42. Fire coöperation
43. Reforestation coöperation
44. Forestry extension, coöperation
45. Timber disposal, coöperation
46. Other coöperation
47. Research

F. Suspense accounts

49. Supplies and other suspense
50. Salaries and wages suspense
51.1. Emergency conservation suspense, expense
51.2. Emergency conservation suspense, investments

Protection accounts and coöperation and miscellaneous accounts comprise those previously mentioned as not being at present classified as expenses and investments.

The preparation of time reports and payroll vouchers nicely illustrates some of the workings of the cost system. For example, we take the monthly time reports of (1) a fire guard employed for the summer fire season, (2) a carpenter on a bridge crew and (3) a foreman in charge of a C.C.C. crew which works on the bridge and fights fires as occasion demands. The guard will be paid from the fund "salaries and expenses," the carpenter may be paid from a road fund, the C.C.C. foreman from the special fund for meeting expenditures for C.C.C. projects.

Suppose the fire guard reports (a) ten days fighting fire No. M2, (b) ten days maintenance of roads and (c) ten days telephone line construction, Big B telephone line. (When fire duties do not take his time, a guard assists with other work that may be in progress near his station.) Let his wages be $90 a month. The charges to funds and cost activities for the fire guard will be

Fund—salaries and expenses		$90
Act. 15, road maintenance	$30	
" 23.1, Big B telephone line	30	
" 40, fire M2	30	

The carpenter might report (a) two days on fire M2, (b) twenty-two days on Little Creek bridge. His wages are $5 a day. If he is paid ordinarily from a road fund, his fire fighting time will be paid from the fire fighting fund. The entries will be

Fund—forest road development		$110
Act. 20, Little Creek bridge	$110	
Fund—fighting forest fires		10
Act. 40, fire M2	10	

The fireman may report (a) fifteen days on Little Creek bridge, (b) five days on fire M2 and (c) general supervision, four days. His wages are $6 a day. Inasmuch as the special fund from which he is paid is usable for fire fighting as well as road work, the entry will be

Fund—special		$144
Act. 1, general overhead	$24	
" 20, Little Creek bridge	90	
" 40, fire M2	30	

The foregoing charges against the funds will be entered in the voucher register thus:

Vo. No.	To whom	Funds			
		S&E	FFF	FRD	Special
2001	Payroll	$90	$10	$110	
2002	"				$144

Incidentally, the extra voucher, No. 2002, illustrates another of the numerous regulations: disbursements from this special fund can not appear on a voucher for regular funds.

Previously the voucher register has been compared to a cash-payments book or cheque register having a dozen credit columns for the banks or appropriations. It is evident that such a register would be rather unwieldy if it also contained the debit distribution for the cost charges. To record the cost items or charges to activities each fund has a ledger. The activity charges are entered directly from the voucher into these ledgers. The same activity accounts are found in each ledger. In this way cost elements are segregated by funds.

In the foregoing time reports it will be noticed that there is a charge to activity 40 for fire M2 under three funds:

Salaries and expenses	$30
Fighting forest fires	10
Special	30

By preparing a recapitulation of all charges to activity 40 for fire M2 from all fund ledgers there is obtained a total cost of $70 for labor on this fire. In other words a recapitulation of all activities in all fund ledgers brings together all charges on each activity. The fund feature of the system disappears and the cost part remains. At the end of the fiscal period such a recapitulation is prepared.

Activity 20 includes expenditures for forest road development. It is a control account much like the account "plant" on a balance-sheet of a commercial establishment. The details of the latter would be found in the plant ledger. So the details of activity 20 would be found in an investment ledger in which would be found the cost of each road and trail of the forest. This means several hundred road accounts for each forest. The total of the control account will amount to several million dollars for a forest. At the close of the fiscal year the fund ledgers are posted to the investment ledgers for activities which represent investments. What has been said of activity 20, forest road development, applies to all the investment accounts so far as the control element is concerned.

It is not the purpose of this article to deal with all the features of the fund-cost-accounting system of the United States forest service. Necessarily much must be omitted. No doubt essentials have been left out which should have been included. For example, a unique plan of using journal vouchers is in use. A method of inter-unit accounting between forests exists. Final reports at the end of the fiscal period are not only reports but form part of the accounting system by which the accounts of the entire system are made to form a consolidated one after the order of a national organization with branches throughout the country.

Students' Department

H. P. BAUMANN, *Editor*

VIRGINIA C. P. A. EXAMINATION

This department has been requested to solve the following problem which was set in a recent examination for the certificate of certified public accountant in the state of Virginia. The allotted time for solving was two and one-half hours.

Problem:

"The American Products Company (of Virginia) entered into an agreement with the common stockholders of (a) Eastern Products Company (of New York) and (b) Northern Products Company (of Maine), whereby the American Products Company acquired, as of January 1, 1935, all the outstanding common capital stock of the Eastern and Northern companies. Payment to the respective stockholders of the Eastern and Northern companies was made in common capital stock of the American Products Company on a relative book-value basis, that is to say, for each dollar of book value of shares acquired the American company issued the equivalent of a dollar book value in its own common shares.

"You are called in to advise the respective companies as to the respective book values and book entries necessary to consummate the transactions called for in the agreement. You are informed that where properties have been 'written up' to appraised values, you are to accept same as representing true book values. You have established post-closing balance-sheets as at December 31, 1934, as follows:

Assets	American Products Company	Eastern Products Company	Northern Products Company
Cash	$ 86,000	$ 5,000	$ 5,000
Accounts and notes receivable—customers	150,000	32,500	20,000
Due from Northern Company		12,500	
Inventories	125,000	60,000	40,000
Miscellaneous stocks and bonds (lower of cost or market)	200,000		
Preferred stock of Northern Products Company, 100 shares at cost		3,000	
Common stock of Northern Products Company, 200 shares at cost		12,000	
American Products Company, N. P. V. Common stock 10,000 shares at cost, held by treasurer	200,000		
Land—cost	100,000	10,000	
Buildings—cost	1,150,000	25,000	
Buildings—appreciation	50,000	5,000	
Machinery—cost	2,170,000	55,000	30,000
Machinery—appreciation	280,000	15,000	10,000
Prepaid insurance	11,000	3,000	1,000
Bond discount to be amortized	35,000		
Other expenses and supplies	4,000	8,000	1,000
	$4,561,000	$246,000	$107,000

Liabilities and net worth	American Products Company	Eastern Products Company	Northern Products Company
Accounts payable—purchases	$ 45,000	$ 13,100	$ 8,500
Accounts payable—due to Eastern Company			12,500
Accrued interest, taxes and expenses	16,000	5,100	1,500
Notes payable—banks		20,300	19,000
Bonds payable—due $50,000 on each July 1st, to July 1, 1942	400,000		
Reserve for depreciation (on cost):			
Buildings	475,000	8,000	
Machinery and equipment	1,425,000	12,000	14,000
Capital stock:			
†Preferred, 6% cumulative, $100 P. V. (dividends in arrears for 2½ years)			10,000
Common, $100 P. V.—authorized and issued		50,000	50,000
Common, no par value—			
Authorized 200,000 shares			
Less-issued 90,000 shares			
Issued 110,000 shares	660,000		
Surplus—earned	1,210,000	117,500	10,500*
Surplus from revaluation of fixed assets	330,000	20,000	2,000
	$4,561,000	$246,000	$107,000

"You also find that the American Products Company has arranged for the following:

I. Surrender of capital stock (and charters) of both the Eastern and Northern companies and the taking over of the assets and assumption of the liabilities of these companies, as of February 28, 1935.

II. Domestication of the American Products Company in New York and Maine, as of February 28, 1935.

III. Consolidation of the accounting of the Eastern and Northern branches in a single unit to be known as the Northeastern Division of the American Products Company, as of February 28, 1935.

"An investigation of the records of the respective companies for the months of January and February, 1935, disclosed the following:

	American Products Company	Eastern Products Company	Northern Products Company	Total
Balance-sheet changes—				
Additions to cash balances	$15,000	$ 1,000	$1,000	$17,000
Increase in customers' receivables	20,000	500	500	21,000
Increase in inventories	15,000	500	100	15,600
Decrease in purchase accounts payable	9,500	4,500	5,000	19,000
Decrease in accrued expenses, etc.	2,200	1,800	250	4,250
Purchase of American Products Company bonds of 7–1–38 maturities	10,000			10,000
Purchase of machinery	12,000	7,500		19,500

† This stock is preferred in liquidation as to assets and all arrearages in dividends.
* Indicates a deficit.

	American Products Company	Eastern Products Company	Northern Products Company	Total
Balance-sheet changes—*cont.*				
Increase in reserve for depreciation:				
Buildings	$ 7,600*	$ 200*	$	$ 7,800*
Machinery	25,600*	600*	500*	26,700*
Decrease in bond discount	1,500*			1,500*
Decrease in other expenses and supplies	1,800*	1,200*	500*	3,500*
Increase in earned surplus account	$47,200	$13,800	$5,850	$66,850

"On the basis of the foregoing information, you are requested to:

"(1) Ascertain the relative book values of the shares of the respective companies as of January 1, 1935.

"(2) Ascertain the number of American shares to be issued (as of January 1, 1935) to:

(a) Eastern common stockholders.
(b) Northern common stockholders.

"(3) Prepare any necessary journal entries to adjust the books of the respective companies so as to reflect the correct relative book values of the respective stocks and to record the acquisition of the Eastern and Northern shares by the American Company as of January 1, 1935.

"(4) Prepare journal entries to record, on the books of the Eastern and Northern companies, the sale of assets to and assumption of liabilities by, the American Products Company and the surrender of their stocks by the American Company as of February 28, 1935.

"(5) Prepare opening entries for the Northeastern Division of the American Products Company as of February 28, 1935.

"(6) Prepare necessary journal entries for the home-office books of American Products Company in connection with the surrender of the stocks of the Eastern and Northern companies.

"(7) Prepare a balance-sheet of American Products Company, including the northeastern division, as of February 28, 1935."

Solution:

(1) The relative book values of the shares of the respective companies as of January 1, 1935, may be determined as follows:

Northern Products Company:

Preferred stock, 6% cumulative, $100 par value, is preferred "in liquidation as to assets and all arrearages in dividends." It is assumed that the preference is measured by the sum of the par value of the stock and an amount measured by the amount of dividends in arrears, regardless of the lack of any surplus from which dividends might have been declared. As the arrearages cover 2½ years at 6% per annum, the liquidating value of the stock may be considered to be:

Par value	$100	
Arrearages (2½×6%) 15%	15	
Total		$115

* Deficit.

Common stock, $100 par value:

The number of shares of common stock is, presumably, ($50,000 ÷ 100) 500. The book value of this stock is:

Capital—stock account		$50,000	
Surplus from revaluation of fixed assets		2,000	
Total		$52,000	
Less—deficit:			
Per balance-sheet	$10,500		
Arrearages ($15 × 100)	1,500	12,000	
Book value of 500 shares		$40,000	
Book value of each share ($40,000 ÷ 500)			$ 80

Eastern Products Company:

The number of shares of common stock is, presumably, $50,000 ÷ 100) 500. The book value of this stock is:

Capital—stock account		$ 50,000	
Earned surplus		117,500	
Surplus from revaluation of fixed assets		20,000	
Increase in value of investments of Northern Products Company:			
Preferred stock:			
Value ($115 × 100)	$11,500		
Cost	3,000	8,500	
Common stock:			
Value ($80 × 200)	$16,000		
Cost	12,000	4,000	
Book value of 500 shares		$200,000	
Book value of each share ($200,000 ÷ 500)			$400

American Products Company:

The number of shares of common stock issued is 110,000, including 10,000 shares carried in the treasury at a cost of $200,000. The number of shares outstanding in the hands of "outsiders" is 100,000. The book value of these 100,000 shares is:

Capital—stock account	$ 660,000	
Earned surplus	1,210,000	
Surplus from revaluation of fixed assets	330,000	
Total	$2,200,000	
Less—cost of treasury stock	200,000	
Book value of 100,000 shares	$2,000,000	
Book value of each share ($2,000,000 ÷ 100,000)		$ 20

(2) The number of shares of the American Products Company to be issued (as of January 1, 1935) is shown below:

Book value per share:	
American Products Company	$ 20
Eastern Products Company	400
Northern Products Company	80

Ratios:
20 shares of American = 1 share of Eastern (400 ÷ 20).
4 shares of American = 1 share of Northern (80 ÷ 20).

Shares to be issued:	Eastern	Northern
Common shares outstanding	500	500
Multiply by	20	4
Number of American Products Company shares to be issued	10,000	2,000

(Since 200 shares of Northern common are held by Eastern Products Company, 800 (200 times 4) of the 2,000 American shares to be issued for the Northern common stock will go to the Eastern company, and upon the dissolution of that company will become treasury stock of the American company.)

(3) Journal entries to adjust the books of the respective companies so as to reflect the correct relative book values of the respective stocks and to record the acquisition of the Eastern and Northern shares by the American company as of January 1, 1935.

(a) Eastern Products Company:

Preferred stock of Northern Products Co.	$ 8,500	
Surplus from revaluation of investments		$ 8,500
To increase the investment in the preferred stock of the Northern Products Co., to reflect the book value of the preferred shares held:		
Liquidating value $115 per share 100 shares owned:		
Value of investment	$ 11,500	
Cost	3,000	
Increase	8,500	
Common stock of Northern Products Co.	$ 4,000	
Surplus from revaluation of investments		$ 4,000
To increase the investment in the common stock of the Northern Products Co., to reflect the book value of the common shares held:		
Book value—$80 per share 200 shares owned:		
Value of investment $16,000		
Cost 12,000		
Increase $ 4,000		

Common stock of American Products Co.......	$ 16,000	
Common stock of Northern Products Co.....		$ 16,000
To record the receipt of 800 shares (book value, $20 per share) of the American Products Co. common stock in exchange for the 200 shares of Northern Products Co. common stock, per agreement.		

(b) Northern Products Company:

Deficit—earned..........................	$ 1,500	
Preferred, 6% cumulative $100 par value....	10,000	
Preferred stock—liquidating value........		$ 11,500
To set out the liquidating value of the 100 shares of preferred stock.		

(c) American Products Company (entry numbers refer to balance-sheet working papers):

(1A)

Common stock of Eastern Products Co., 500 shares of $100 par value—book value.....	$200,000	
American Products Co.—treasury stock.		$200,000
To record the exchange of 10,000 shares of treasury stock for 500 shares of common stock of the Eastern Products Co.		

(NOTE.—As nothing is stated as to the purpose for which the 10,000 shares were held in the treasury, it is assumed that the 10,000 shares of treasury stock which were carried at the cost of $20 per share were exchanged for the 500 shares of Eastern Products Company stock which has the same total book value of the treasury shares.)

(2A)

Common stock of Northern Products Co., 500 shares of $100 par value—book value.....	$ 40,000	
Common stock, no par value...........		$40,000
To record the issuance of 2,000 shares of no-par common stock in exchange for 500 shares of $100 par value common stock of the Northern Products Company, per agreement.		

(4) Journal entries to record, on the books of the Eastern and Northern companies, the sale of assets to and assumption of liabilities by the American Products Company and the surrender of their stocks by the American Company as of February 28, 1935.

The account balances January 1, 1935, are adjusted for the entries in (3) above, and the transactions of the two companies during the two months from January 1, 1935, to February 28, 1935, in computing the amounts shown in the following journal entries.

Eastern Products Company

	Balances, January 1, 1935, after entries in (3)	Transactions and adjustments (Increase-Decrease*)	Journal entry Debit	Journal entry Credit
Due from Northern Products Company			$ 11,500	
Preferred stock—Northern Products Company				$ 11,500
To set up this preferred stock at liquidating value in the current account of the Northern Company—since the latter is being dissolved, no provision has been made for payment of the preferred stock in liquidation, and both companies are 100% owned by American, transfer of the investment and the capital-stock account, respectively, on the two sets of books, to the current accounts, accomplishes the payment.				
American Products Company			213,800	
Accounts payable—purchases	$ 13,100	$ 4,500*	8,600	
Accrued interest, taxes, expenses	5,100	1,800*	3,300	
Notes payable—banks	20,300		20,300	
Reserve for depreciation:				
Buildings	8,000	200	8,200	
Machinery and equipment	12,000	600	12,600	
Cash	5,000	1,000		6,000
Accounts and notes receivable	32,500	500		33,000
Due from Northern Products Company	12,500	11,500		24,000
Inventories	60,000	500		60,500
Common stock—American Products Company	16,000			16,000
Land—cost	10,000			10,000
Buildings—cost	25,000			25,000
Buildings—appreciation	5,000			5,000
Machinery—cost	55,000	7,500		62,500
Machinery—appreciation	15,000			15,000
Prepaid insurance	3,000			3,000
Other expenses and supplies	8,000	1,200*		6,800
To record acquisition of assets and assumption of liabilities by American Products Company.				
Capital stock—common			50,000	
Surplus—earned	$117,500	$13,800	131,300	
Surplus from revaluation of fixed assets			20,000	

	Balances, January 1, 1935, after entries in (3)	Transactions and adjustments (Increase-Decrease*)	Journal entry Debit	Credit
Surplus from revaluation of investments			12,500	
American Products Company				213,800

Surrender of stock by sole stockholder, American Products Company, in exchange for net assets transferred. This company dissolved.

NORTHERN PRODUCTS COMPANY

			Debit	Credit
Preferred stock—liquidating value			$ 11,500	
Due to Eastern Products Company				$ 11,500

To transfer amount due on preferred stock at liquidation to current account of sole stockholder.

	Balances	Transactions	Debit	Credit
American Products Company			45,850	
Accounts payable—purchases	$ 8,500	$ 5,000*	3,500	
Due to Eastern Products Company	12,500	11,500	24,000	
Accrued interest, taxes and expenses	1,500	250*	1,250	
Notes payable—banks	19,000		19,000	
Reserve for depreciation—machinery	14,000	500	14,500	
Cash	5,000	1,000		6,000
Accounts and notes receivable	20,000	500		20,500
Inventories	40,000	100		40,100
Machinery—cost	30,000			30,000
Machinery—appreciation	10,000			10,000
Prepaid insurance	1,000			1,000
Other expenses and supplies	1,000	500*		500

To record acquisition of assets and assumption of liabilities by American Products Company.

	Balances	Transactions	Debit	Credit
Capital stock—common			50,000	
Surplus from revaluation of fixed assets			2,000	
Surplus (deficit*)—earned	12,000*	5,850		6,150
American Products Company				45,850

Surrender of stock by sole stockholder, in exchange for net assets transferred. This company dissolved.

(5) Opening entries for the Northeastern division of the American Products Company as of February 28, 1935.

NORTHEASTERN DIVISION

Opening journal entries, February 28, 1935

Cash	$ 6,000	
Accounts and notes receivable	33,000	
Eastern—Northern current account	24,000	
Inventories	60,500	
Treasury stock—American Products Company	16,000	
Land—cost	10,000	
Buildings—cost	25,000	
Buildings—appreciation	5,000	
Machinery—cost	62,500	
Machinery—appreciation	15,000	
Prepaid insurance	3,000	
Other expenses and supplies	6,800	
Accounts payable—purchases		$ 8,600
Accrued interest, taxes and expenses		3,300
Notes payable—banks		20,300
Reserve for depreciation:		
Buildings		8,200
Machinery		12,600
Home-office account		213,800

Assets and liabilities of Eastern Products Company.

Cash	$ 6,000	
Accounts and notes receivable	20,500	
Inventories	40,100	
Machinery—cost	30,000	
Machinery—appreciation	10,000	
Prepaid insurance	1,000	
Other expenses and supplies	500	
Accounts payable—purchases		$ 3,500
Eastern—Northern current account		24,000
Accrued interest, taxes and expenses		1,250
Notes payable—banks		19,000
Reserve for depreciation—machinery		14,500
Home-office account		45,850

Assets and liabilities of Northern Products Company.

"(6) Prepare necessary journal entries for the Home Office books of American Products Company in connection with the surrender of the stocks of the Eastern and Northern companies."

(3A)

Common stock of Eastern Products Co.	$13,800	
Surplus		$ 13,800

To take up two months' earnings of Eastern company.

(4A)

Common stock of Northern Products Co.	$ 5,850	
Surplus		$ 5,850
To take up two months' earnings of Northern company.		
Northeastern division—branch investment	$259,650	
Common stock of Eastern Products Co.		$213,800
Common stock of Northern Products Co.		45,850
To record dissolution of subsidiaries and transfer of their assets and liabilities to the Northeastern division, to be operated as a division of this company. For assets and liabilities accounting for the net assets of $259,650, see opening entries of Northeastern division. (The same effect may be obtained by setting up the assets and liabilities of the two dissolved companies in this entry and then immediately transferring them to the Northeastern division.)		

In the above entries, and throughout the solution, I have disregarded the dividends accrued on the Northern preferred stock—held by the Eastern company—for the months of January and February, 1935.

AMERICAN PRODUCTS COMPANY
Balance-sheet working papers—February 28, 1935

Assets	Balance-sheet December 31, 1934	Transactions (x) and adjustments Increase-Decrease*		Assets and liabilities of Northeastern division: Eastern	Northern	Balance-sheet February 28, 1935	
Cash	$ 86,000	(x)	$ 15,000	$ 6,000	$ 6,000	$ 113,000	
Accounts and notes receivable—customers	150,000	(x)	20,000	33,000	20,500	223,500	
Inventories	125,000	(x)	15,000	60,500	40,100	240,600	
Miscellaneous stocks and bonds (lower of cost or market)	200,000					200,000	
American Products Co., no par value common stock	200,000	(1A)	200,000*	16,000		16,000	
Land—cost	100,000			10,000		110,000	
Buildings—cost	1,150,000			25,000		1,175,000	
Buildings—appreciation	50,000			5,000		55,000	
Machinery—cost	2,170,000	(x)	12,000	62,500	30,000	2,274,500	
Machinery—appreciation	280,000			15,000	10,000	305,000	
Prepaid insurance	11,000			3,000	1,000	15,000	
Bond discount to be amortized	35,000	(x)	1,500*			33,500	
Other expenses and supplies	4,000	(x)	1,800*	6,800	500	9,500	
	$4,561,000						
Common stock of Eastern Products Co.		(1A)	200,000	213,800*			
		(3A)	13,800				
Common stock of Northern Products Co.		(2A)	40,000		45,850*		
		(4A)	5,850				
American Products Co., bonds due 7-1-38		(x)	10,000			10,000	
Northern—Eastern current account				24,000	24,000*		
			$128,350	$53,000	$38,250		
Liabilities and net worth							
Accounts payable—purchases	$ 45,000	(x)	$ 9,500*	$ 8,600	$ 3,500		$ 47,600
Accrued interest, taxes and expenses	16,000	(x)	2,200*	3,300	1,250		18,350
Bonds payable—due $50,000 on each July 1st, to July 1, 1942	400,000						400,000
Reserve for depreciation—(on cost):							
Buildings	475,000	(x)	7,600	8,200			490,800
Machinery and equipment	1,425,000	(x)	25,600	12,600	14,500		1,477,700
Notes payable—banks				20,300	19,000		39,300
Common stock, no par value	660,000	(2A)	40,000				700,000
		(x)	47,200				
Surplus—earned	1,210,000	(3A)	13,800				1,276,850
		(4A)	5,850				
Surplus from revaluation of fixed assets	330,000						330,000
	$4,561,000		$128,350	$53,000	$38,250	$4,780,600	$4,780,600

AMERICAN PRODUCTS COMPANY
(Including Northeastern Division)
Balance-sheet—February 28, 1935

Assets

Current assets:			
Cash		$ 113,000	
Accounts and notes receivable—customers		223,500	
Inventories		240,600	$ 577,100
Miscellaneous stocks and bonds			200,000
Fixed assets:			
Land—cost		$ 110,000	
Buildings (cost $1,175,000)			
Appreciated value	$1,230,000		
Less reserve for depreciation	490,800	739,200	
Machinery (cost $2,274,500)			
Appreciated value	$2,579,500		
Less reserve for depreciation	1,477,700	1,101,800	1,951,000
Deferred charges:			
Prepaid insurance		$ 15,000	
Bond discount		33,500	
Other expenses and supplies		9,500	58,000
			$2,786,100

Liabilities and net worth

Current liabilities:			
Accounts payable—purchases		$ 47,600	
Notes payable—banks		39,300	
Accrued interest, taxes and expenses		18,350	
Bonds payable—instalment due July 1, 1935		50,000	$ 155,250
Bonds payable—			
Due $50,000 annually on July 1, 1936 to 1942		$ 350,000	
Less treasury bonds (due July 1, 1938)		10,000	340,000
Net worth:			
Capital stock—no par value:			
Authorized, 200,000 shares;			
Issued, 112,000 shares	$700,000		
In treasury—800 shares	16,000		
Outstanding, 111,200 shares		$ 684,000	
Surplus:			
Earned		1,276,850	
Arising from revaluation of fixed assets		330,000	2,290,850
			$2,786,100

NOTE.—Since appraised values of properties are to be accepted as representing true book values, no adjustment can be made for them, even though it appears that no depreciation of appreciation has been taken by the American and Eastern companies.

Correspondence

WORK OF COMMITTEE ON GOVERNMENTAL ACCOUNTING

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: I have observed the interesting discussion concerning surplus accounts in a municipal balance-sheet in the April issue of THE JOURNAL OF ACCOUNTANCY and would like to add these additional observations. The fact that, as one writer suggests, "There is not any single recognized procedure" has been until recently one of the outstanding difficulties in the field of municipal and other governmental accounting. It is for that reason and in recognition of the need for a more nearly uniform terminology and procedure through the whole realm of municipal accounts that the National Committee on Municipal Accounting, which was referred to by one of the writers, has been set up. This committee, which was organized about two years ago, consists of representatives of the American Institute and other national accounting bodies and of national organizations of public officers. Each organization has one representative on the committee and also has a subcommittee to advise this representative. Altogether, over sixty persons are associated in this work, including many persons who have been actively interested in the subject and many practising accountants.

The purpose of this committee is to "formulate principles of municipal accounting, to develop standard classifications and terminology for municipal reports and to promote the recognition and use of those standards". Five bulletins have already been published by the committee dealing with terminology, balance-sheets, audit procedure and bibliography. Another important bulletin dealing with forms of all kinds of municipal financial statements will be published shortly.

The activities and proposals of that committee have already attracted wide interest and a substantial degree of recognition. A number of municipal reports of the current year have been compiled in accordance with the committee's recommendations. Through this channel, an opportunity is presented for the development of an authoritative procedure which should be of interest and aid to all accountants and public officers. The work of this committee should do much to eliminate the variation and uncertainties in this field of accounting and to bring about greater unification and standardization of both principles and practice.

Yours truly,

LLOYD MOREY, *Chairman*,
Institute Special Committee on Governmental Accounting.

Urbana, Illinois, April 20, 1936.

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.]

UNAMORTIZED DEBT DISCOUNT, EXPENSE AND PREMIUMS ON BONDS REFUNDED

Question: In view of changed economic conditions, is it now regarded as good accounting practice to carry forward the unamortized debt discount and expense of and premiums paid on bonds refunded and to spread these items over the life of a new refunding bond issue, together with the discount and expense incident to the new issue?

To be more specific, let us assume the following: A company issues $10,000,000 of 3%, 25-year bonds, and the discount and expense incident thereto amount to $300,000. The proceeds of this 3% issue are applied to the redemption, at 104%, of a 6% $10,000,000 prior 20-year issue, which still has 10 years to run and on which the unamortized debt discount and expense amounts to $200,000.

Should the $400,000 premium paid on the old bonds refunded, with the $200,000 balance in the debt discount and expense account, be written off at the time the old bonds are refunded or may the sum of the two, viz., $600,000, be added to the $300,000 discount and expense incident to the new issue and the total, viz., $900,000, be amortized over a period of 25 years, the life of the new bond issue?

Also, if it is not considered proper to carry forward both the debt discount and expense and the premium incident to the old issue, would it be proper to write off the former and to carry forward the latter on the theory that the premium was paid solely as an incident of the new issue?

Also, if the bonds were those of a public-utility corporation, should special consideration be given to that fact?

Answer No. 1: I believe that the correct solution of the problem submitted is in no way affected by economic conditions. It is ordinarily a matter of the proper periodical distribution of the cost of borrowed money. I do not consider in the circumstances cited that it would be proper to charge surplus with the amount of discount and expense remaining unamortized at the date of refunding. To do this would imply that the amount thus written off represented cost of money for the past period whereas, in reality, it represents part of the cost of money for the ten years following. The treatment which should be accorded in respect, not only to the discount and expense remaining but also to the premium paid on the retirement of the old issue, would be to apportion these charges equitably over the period for which the old bonds were still to run.

It is apparent that the new bonds were issued for two reasons: First, to provide funds at a lower cost than was being borne while the old bonds were outstanding and, second, to provide funds for a longer period. The total expense of the new bond issue for discount and expense should, therefore, be equally distributed over the entire period of its life. The effect of this will be to charge the first ten years with part of the cost of the old and part of the cost of the new and to charge the remaining fifteen-year life with an equitable proportion of the cost of the new issue.

It is evident that this is reasonable for, even with the total charge, the cost of money will be less for the first ten years of the new issue than would have been the case if the old bond issue had been allowed to remain in force.

The answer to this question is definitely "yes." The accounts of a public utility corporation are very strictly regulated by the commission under whose jurisdiction it operates, and definite consideration must be given to the regulations which have been prescribed.

Answer No. 2: In our opinion it is permissible to amortize as a financial cost the old discount and expense plus the premium paid on the old bonds refunded over the period covered by the new issue.

There is, however, an important income-tax situation in this problem, which should be considered in the interest of the client. If the new bonds are merely a substitution and were not issued to the public through the usual financial procedure, the deferred discount and expense on the old bonds at the time of refunding will not be allowed as a deduction for income-tax purposes after the refunding date. The treasury department has been upheld in its contention that where a new issue of bonds is used to retire an old issue by substitution only, all deferred discount and expense of the old issue must be regarded as a deduction for income-tax purpose in the period prior to the date of refunding.

OFFICERS' SALARIES IN CONSTRUCTION OF NEW PLANT

Question: A parent company organizes a subsidiary corporation (wholly owned) to construct and operate a new plant. The officers of the parent company devote a considerable time to the new enterprise and, therefore, feel that a part of their salaries and parent company expenses is chargeable as capital cost of constructing the new plant, placing such items in the same category as interest cost of financing during construction. Is this a general and acceptable procedure among companies constructing new plants?

Answer No. 1: We have your request in which is propounded the question of capitalizing part of the time of the principal executives of a company who are removed from supervision of the going plants for a period in order to supervise new capital expenditure, in this particular case related to the establishment of an entirely new plant. While an argument may be adduced in favor of this practice, our general feeling on the subject would be in the negative. We believe that the normal salaries of all executives of a company which must continue in any circumstances, whether these executives are engaged in current operations or in new development, should be looked upon as current necessary costs of the business and as such charged at all times to current profit and loss.

Answer No. 2: We know from actual experience that the general and acceptable procedure among companies constructing new plants is not to capitalize a portion of the salaries of officers engaged partly in supervision of construction. Nevertheless, it appears to us that if it is possible accurately to ascertain the proportionate value of executives' time spent in planning the work of financing and construction of the new plant, it would be proper accounting to capitalize that proportion of executive salaries, together with traveling expenses incurred. It seems to us that the difficulty would be to segregate correctly the executives' time, because it is possible that such time spent at the main office on the company's affairs as a whole had not been impaired; consequently there would be no justification for relieving the current operations of an expense rightfully chargeable to that period.

NOTES PAYABLE AND LIABILITIES ON BALANCE-SHEET

Question: How much of notes payable given for the purchase of equipment, which mature monthly, beginning with February 1, 1936, for a period of eighteen months thereafter, should be included as current liabilities in the preparation of a balance-sheet at December 31, 1935? Should the line be drawn between current liabilities and deferred liabilities at, say, six months or twelve months?

Answer: In our opinion, notes payable maturing within twelve months subsequent to the date of any balance-sheet should be included in such statement as current liabilities, and notes maturing at a period later than twelve months subsequent to the date of the balance-sheet need not be included in current liabilities. This rule may be modified, if warranted by the existence of trade practices in respect to instalment notes.

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