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CONTENTS

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THE JOURNAL OF ACCOUNTANCY

CONTENTS FOR JUNE, 1917

THE JOURNAL OF ACCOUNTANCY is the organ of the professional accountants of the United States. In its articles and editorial columns it treats, from the accountant's point of view, of business problems and conditions.

The editor will be glad to receive and to consider for publication articles from well-informed persons, and will welcome especially contributions from public accountants. The manuscripts of articles not available for publication will be returned on request.

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Uniform Accounting*

PREFACE TO PAMPHLET REPRINT

The following tentative proposal for a uniform system of accounting to be adopted by manufacturing and merchandising concerns appeared in the April (1917) number of the Federal Reserve Bulletin, and is now reprinted for more general distribution.

It is recognized that banks and bankers have a very real interest in the subject, because they are constantly passing upon credits based upon statements made by manufacturers or merchants.

It is quite as much of vital interest to merchants and manufacturers, because they realize that their credit sometimes suffers by reason of losses incurred by bankers through credits given to merchants and manufacturers whose statements do not correctly reflect true conditions.

Lastly, it is of immense importance to auditors and accountants, because they have a professional as well as a practical interest in having the character of their professional work thoroughly formulated and standardized. Losses incurred by bankers by reason of credits given to merchants or manufacturers, if such credits were given because the statements were either actually false or misleading in their nature, tend to discredit accountancy as a profession and to shake the confidence of bankers in the real value of any statements.

Hence it is that the Federal Reserve Board puts out this tentative proposal with the hope of encouraging the fullest criticism and discussion.

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*Reprinted from the *Federal Reserve Bulletin*, April, 1917.

Introduction.

Through the courtesy of the Federal Trade Commission the Federal Reserve Board has been enabled to take advantage of a large amount of information and data which the trade commission acquired in connection with the study of the statements made by merchants, manufacturers, etc., as showing the condition of their business. Because this matter was clearly of importance to banks and bankers, and especially to the federal reserve banks which might be asked to rediscount commercial paper based on borrowers' statements, the Federal Reserve Board has taken an active interest in the consideration of the suggestions which have developed as a result of the trade commission's investigation, and now submits in the form of a tentative statement certain proposals in regard to suggested standard forms of statements for merchants and manufacturers.

The problem naturally subdivides itself into two parts:

(1) The improvement in standardization of the forms of statements.

(2) The adoption of methods which will insure greater care in compiling the statements and the proper verification thereof.

In recent years bankers, through their associations and otherwise, have made rapid progress in the direction of more uniform and complete forms of statements. Much has also been accomplished in the improvement of the quality of the statements rendered and in securing statements which do not depend for their accuracy on the borrower's statement alone but are verified to a greater or less extent by independent scrutiny and audit. The advantage of a statement certified by trustworthy public accountants over an unverified statement is evident. At the present time, however, there is no uniformity as to the extent of verification in the case of statements put forward as having been verified.

The Federal Trade Commission in the course of its investigation of business conditions has been strongly impressed with the lack of uniformity and has enlisted the aid of the American Institute of Accountants, with a view to remedying the condition. It has found that verified statements may be divided broadly into—

(*a*) Those in which the certificate is based on an examination of the books without personal supervision of inventories and independent appraisal of all assets with the aid of technical appraisers; and

(*b*) Statements verified with the personal supervision of inventories and independent appraisal of all assets.

The value of the two classes of audits and their relation to each other depends to a great extent upon the character and magnitude of the business involved.

In some cases method (*b*) has advantages over method (*a*). In other cases, notably those of large companies in which personal supervision of inventories is arduous and perhaps impracticable and the value of an independent appraisal of assets is liable to be considerably exaggerated, the reverse may be true. That is to say, a verification based upon the books themselves without an appraisal may be and often is the safer method of procedure. It is highly desirable gradually to educate the business world to the great importance of a complete form of audit statement, although any plan for immediate adoption intended to produce practical results must recognize that under present practice probably more than 90 per cent. of the statements certified by public accountants are what are called balance-sheet audits, such as are described in paragraph (*a*) above referred to.

As a first step toward the standardization of balance-sheet audits and to insure greater care in compiling and verifying statements the Federal Trade Commission requested the American Institute of Accountants to prepare a memorandum on balance-sheet audits. This memorandum was duly prepared and approved by the council of the institute representing accountants in all sections of the country.

After approval by the Federal Trade Commission the memorandum was placed before the Federal Reserve Board for consideration. The Federal Reserve Board, after conferences with representatives of the Federal Trade Commission and the American Institute of Accountants, and a careful consideration of the memorandum in question, has accepted the memorandum, given it a provisional or tentative endorsement, and submitted it to the banks, bankers, and banking associations throughout the country for their consideration and criticism.

The recommendations in the memorandum apply primarily to what are known as balance-sheet audits. This is an initial step which may easily be succeeded by future developments tending still further to establish uniformity and covering more fully the field of financial statements.

GENERAL INSTRUCTIONS FOR A BALANCE-SHEET AUDIT OF A MANUFACTURING OR A MERCHANDISING CONCERN

The scope of a balance-sheet audit for a fiscal year or other operating period of an industrial or mercantile corporation or firm comprises a verification of the assets and liabilities, a general examination of the profit and loss account, and, incidental thereto, an examination of the essential features of the accounting.

Trial balances of the general ledger, both at the beginning and end of the period under review, should be prepared in comparative form and checked with the ledger. The items in the trial balances should be traced into the balance-sheets before the assets and liabilities are verified, to prove, among other things, that no "contra" asset or liability has been omitted from the accounts, that the assets and liabilities have been grouped in the same manner at the beginning and at the end of the period, and also that the balance sheets are in accordance with the books. The disposition of any general ledger assets and liabilities that may have been scrapped, sold, written off, or liquidated during the period under review should be traced and noted in the working papers. Furthermore, a general scrutiny of the general ledger should be made to see that the accounts, if any, that have been opened and closed during the year have no bearing on the company's financial position at the close of the fiscal period.

The auditor should obtain a copy each of the balance sheets at the beginning and the end of the period to be audited, and should make a comparison between them, so that a comprehensive view may be had by him of the changes in the figures during the period under review. A statement of the disposition of the profits should then be prepared from this comparative balance-sheet as a further aid in impressing the meaning of the figures upon the mind of the auditor.

The verification of assets and liabilities for convenience will be considered in the order in which the items appear in the form of balance-sheet attached hereto. This form of statement has been determined by the desire to meet as nearly as possible the requirements and practice of federal reserve banks.

SPECIFIC INSTRUCTIONS AND SUGGESTIONS RELATING TO THE SEPARATE HEADINGS. CASH.

The cash on hand preferably should be counted after banking hours on the last day of the fiscal period to be covered by the audit, and the amount thereof, together with the cash stated to be in the bank, reconciled with that shown by the cashbook. The cash, bills receivable, and investments must be examined on the same day, so as to make it impossible for a treasurer to make up a shortage in one asset by withdrawing negotiable funds temporarily from another.

In counting the cash on hand the auditor must see that all customers' cheques produced to him as part of the cash balance have been duly entered in the cashbook prior to the close of the period and should note the dates and descriptions of such cheques, and also the dates and descriptions of all advances made from cash and not recorded on the books. Advances to employees should be strictly investigated, and if any are secured by personal cheques the auditor should see that the cheques are certified by the bank on which they are drawn before the close of the audit.

Certificates must be obtained, as of the evening of the closing date, from the banks in which cash is deposited, by or mailed directly to, the auditor himself. The balances as shown by the certificates must be reconciled with those shown on either the cashbook, chequebook stubs, or bank registers, taking into consideration outstanding cheques.

In verifying the outstanding cheques there is only one safe and satisfactory method of proving their accuracy, and that is to compare the credit side of the cashbook from the last day of the fiscal period backward, item by item, with the cheques returned from the bank for such period as may be necessary to account for all current outstandings. Any old cheques not yet cashed by banks should be made the subject of special inquiry. When this work is completed, a list of the outstanding cheques so ascertained should be prepared, showing the dates of the cheques and compared with the actual cheques returned from the bank at a later date, and any not so returned should be specially investigated. Special care is necessary to see that no cheques for cash purposes are drawn at the close of the period and entered in the next period.

Where the currency and bank transactions are kept together in the cashbook and the auditor does not count the cash until a date subsequent to the close of the fiscal year, he must, in addition to verifying the bank balances as of the close of the year, verify them as of the date of the count of cash. This is absolutely essential when it is considered that, although the cash on hand, which forms only part of the balance, at the date of the count is correct, it does not follow that the total cash is correct.

When receipts are shown in the cash books as being deposited in the bank on the last day of the fiscal period, but are included in the reconciliation statement on account of their not being paid into the bank until the next day, the auditor must obtain letters from the banks acknowledging such deposits.

The deposits shown in the pass books should be checked in detail for the last two or three days of the fiscal period from the books to prove that they were composed of bona fide cheques, and that no cheque drawn by the company was deposited in a bank without being credited to the bank on which it was drawn prior to the close of the fiscal period.

So that the auditor may satisfy himself that deposits are promptly made in bank each day, and that the same cheques are paid into bank as are received, it is advisable to call for a number of deposit slips and compare them with the receipts as shown by the cashbook for the days in which the deposits are made. To make such verification absolute the deposit slips should be obtained from the banks.

When the practice of a company is to pay all of its cash receipts into bank, they should be compared and reconciled with the total deposits, as shown by the bank books, and similarly the disbursements should be reconciled with the total cheques drawn.

Outstanding cheques not examined at a previous audit on account of not having been returned by the banks must be called for and traced into the cashbook at the beginning of the current audit.

NOTES RECEIVABLE

A list of notes receivable outstanding at the end of the fiscal period should be prepared, showing the dates the notes are made, the customers' names, the date due, the amounts of the notes and the interest, if any, contained in the notes. If discounted, the name of the discounting bank should be noted and verification obtained from the bank.

The outstanding notes must be carefully examined with the notes-receivable book, and with the list prepared by or produced to the auditor, the due dates and the dates of making the notes being carefully checked, and when notes have been renewed the original dates should be recorded. When notes have been paid since the close of the fiscal year, the cash should be traced into the books of the company, and, when they are in the hands of attorneys or bankers for collection, certificates should be obtained from the depositaries.

When notes receivable are discounted by banks the company has a liability therefor which should appear on the balance-sheet. Lists of discounted notes not matured at the date of the audit should be obtained from the banks as verification and their totals entered under 20a if the cash therefor is shown as an asset.

The value of collateral, if any, held for notes should be ascertained, as it frequently happens that the notes are worth no more than the collateral.

Notes due by officials and employees must always be stated separately from customers' notes, as must also notes received for other than trade transactions.

Notes due from affiliated concerns must not be included as customers' notes, even though received as a result of trading transactions. Affiliated companies' notes should be shown as a separate item of current assets or as other assets as the circumstances warrant. They may be fairly included in current assets if the debtor company has ample margin of quick assets over its liabilities, including such notes.

The term "quick assets" is used here in the sense in which it is used by federal reserve practice. "Current assets" is used to comprise these assets and other assets which, though current, are excluded in determining the eligibility of the paper for federal reserve purposes.

Optional.—The best verification of notes receivable is an acknowledgment by the party named in each note as the payor on the due date that the note is a bona fide obligation. Therefore if time permits, and the client does not object, it is advisable to obtain such written confirmation for each note. The auditor should personally mail the letters, enclosing stamped envelope for reply addressed direct to himself.

ACCOUNTS RECEIVABLE.

The bookkeepers of the accounts-receivable ledgers should be asked to draw off lists of the open balances at the end of the fiscal period, and distributions of the total columns should be shown on the lists according to the age of the accounts, e. g., not yet due, less than 30 days past due, more than 30 days past due. The accounts paid since the close of the fiscal period should be noted in the lists before taking up the matter of past-due accounts with the credit department, as payment is the best proof that an account was good at the date of the audit.

The totals of the lists of outstanding accounts should agree with the controlling account in the general ledger if separate ledgers are kept. When credit balances appear on customers' accounts they should be shown on the balance-sheet as a separate item and not deducted from the total of debit balances; and debit balances on the accounts-payable ledgers should be treated in the same manner.

The lists must be footed and compared in detail with the customers' accounts in the ledgers.

The composition of outstanding balances should always be examined, as it frequently happens that while a customer may be making regular payments on his account, old items are being carried forward which have been in dispute for a considerable period of time. Such items and accounts which are past due should be taken up with the credit department or some responsible officer, and the correspondence with the customers examined, so that the auditor may form an opinion of the worth of the accounts and satisfy himself that the reserve for bad and doubtful accounts set up by the company is sufficient.

Trade discounts (and also so-called cash discounts, if exceeding 1 per cent) and freights allowed by the company should be inquired into, and if they have been included in the accounts receivable a reserve therefor should be set up in the balance-sheet. Also inquiries should be made regarding customers' claims for reductions in prices and for rebates and allowances on account of defective materials, so that it may be seen that a sufficient reserve has been established therefor.

Inquiry must be made as to whether any of the accounts receivable have been hypothecated or assigned, and the sum total of accounts so listed entered under 20b.

The auditor should satisfy himself that the bad debts written off have been duly authorized by responsible officials.

Accounts due from directors, officers, and employees must be stated in the balance sheet separately and not included as trade accounts. This applies also to deposits as security, guaranties, and other extraordinary items not connected with sales.

Accounts due from affiliated concerns must not be included as customers' accounts, even though arising as a result of trading transactions. Affiliated companies' accounts should be shown as a separate item of "current assets" or as "other assets," as the circumstances warrant. They may be fairly included as "current assets" if the debtor company has ample margin of quick assets over its liabilities, including such accounts.

Optional.—The best verification of an open balance is a confirmation by the customer; therefore, if time permits and the client does not object, it is advisable to circularize the customers. The auditor should personally see the circulars mailed after comparing them with the lists of outstanding accounts. The envelopes for replies sent with the circulars should be addressed direct to the auditor.

In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid and not correctly credited on the accounts-receivable ledgers, but in small concerns, with imperfect systems, such occurrences are quite impossible, so much so, in fact, that it is generally admitted that the risk of errors and omissions decreases in direct proportion to an increase in bookkeeping.

SECURITIES.

Under this caption must be listed securities in which surplus funds of the company or firm have been temporarily invested and which are considered available as "quick assets," i. e., can be turned into money in time of need. Where stocks or bonds represent control or a material interest in other enterprises, the ownership of which carries more or less value to the holder outside of the return thereon, they should be considered as fixed assets.

A list of investments should be prepared showing—

The dates of purchases.

Descriptions of the investments.

Par value of the investments.

The denomination of the shares.

The number of shares or bonds owned.

The total capital stock of the various companies.

The amounts paid for the investments.

The interest and dividends received.

The market values of the investments.

The surplus or deficit shown by the balance-sheets of the companies where no market quotations are available.

If hypothecated, with whom and for what purpose.

This list must be compared with the ledger accounts concerned and the total of amounts paid according to the list must agree with the balance of the investment account or accounts.

The securities must be examined by the auditor in person or he must secure confirmation of their existence from those who hold them as collateral. Those in possession of the company must be counted and examined as soon as possible after the audit starts, and all of them must be submitted to him at one time. It is much more satisfactory to see the actual securities than to verify cash receipts and other evidences therefor after the audit has progressed some time.

Certificates out for transfer must be verified by correspondence.

Where the market values of securities are less than the book values, save where the variation is so small as to be trifling, a reserve for loss in value on the balance-sheet date must be set up.

Care must be taken to see that the certificates are made out in favor of the company, or that they are endorsed or accompanied by powers of attorney when they are in the names of individuals.

Coupons on bonds must be examined to see that they are intact subsequent to the latest interest payment date.

The investment schedule must show that the total interest and dividends receivable by the company have been duly accounted for; the income from the investments shown in the profit and loss account must be in accord with this schedule.

When market quotations can not be obtained for investments, the balance sheets of the companies in which investments are held must be examined so that the auditor may form an idea of their value.

In verifying purchases of stock exchange securities the brokers' advices must in all cases be examined in connection with the verification of the purchase price.

Investments in deeds and mortgages must be supported by both the mortgages and insurance policies, and, furthermore, it must be shown that all assessed taxes on the property have been duly paid, that the mortgages have been properly recorded, and that the insurance policies are correctly made out to the company.

If any of the securities have been hypothecated the fact and amount (book value) must be stated under 20d of the balance-sheet.

INVENTORIES.

Under this caption must be included only stocks of goods owned and under control of the owner. Stocks are often hypothecated and if this is the case the fact should be stated on the balance-sheet.

Inasmuch as the accuracy of the profit and loss account is absolutely dependent upon the accuracy of the inventories of merchandise at the beginning and end of the period under review, this part of the verification should receive special attention. When a balance-sheet audit is being made for the first time, the inventory at the beginning of the period should receive as much attention as that at the end, and the auditor should take every precaution to satisfy himself that both inventories were taken on the same basis.

An acceptable programme of audit for inventories is as follows:

(1) Secure the original stock sheets if they are in existence and carefully test the typewritten copies with them and with tickets, cards, or other memoranda that show the original count.

(2) See that the sheets are certified to or initialed by the persons who took the stock, made the calculations and footings, and fixed the prices, and satisfy yourself that they are dependable and responsible persons. Obtain a clear and detailed statement in writing as to the method followed in taking stock and pricing it; also a certificate from a responsible head as to the accuracy of the inventory as a whole.

(3) A thorough test of the accuracy of the footings and extensions should be made, especially of all large items.

(4) The inventories should be compared with the stores ledger, work in progress ledgers and finished product records and stock records as to quantities, prices, and values, and any material discrepancy should be thoroughly traced.

(5) Where stock records are kept and no physical inventory is taken at the time of the audit, ascertain when the last physical inventory was taken and compare it with the book records. If no recent comparison is possible, select a few book items of importance and personally compare with the actual stock on hand.

(6) Where no stock records are kept, a physical inventory should be taken preferably under the general direction of the auditor. After the inventory is completed, he should apply the same tests to verify its accuracy as if the inventory had been taken before his arrival upon the scene.

(7) When the cost system of a company does not form a part of the financial accounting scheme there is always a chance that orders might be completed and billed, but not taken out of the work in progress records. Especially is this the case when reliance is placed on such records to the extent that a physical inventory is not taken at the end of the period to verify the information shown therein. In these cases the sales for the month preceding the close of the fiscal period should be carefully compared with the orders in progress as shown by the inventory, to see that nothing that has been shipped is included in the inventory in error. Cost systems which are not coördinated with the financial accounts are unreliable and frequently mis-

leading. Special attention should be called to every case in which the cost system is not adequately checked by the results of the financial accounting.

(8) Ascertain that purchase invoices for all stock included in the inventory have been entered on the books. Look for postdated invoices and give special attention to goods in transit.

(9) See that nothing is included in the inventory which is not owned but is on consignment from others. If goods consigned to others are included, see that cost prices are placed thereon, less a proper allowance for loss, damage, or expenses of possible subsequent return. This does not include goods at branches, as the valuing of such stocks will be governed by the same principles as apply at the head office.

(10) Ascertain that nothing is included which has been sold and billed, and is simply awaiting shipment.

(11) If duties, freight, insurance, and other direct charges have been added, test them to ascertain that no error has been made. Duties and freight are legitimate additions to the cost price of goods, but no other items should be added except under unusual circumstances.

(12) As a check against obsolete or damaged stock being carried in the inventory at an excessive valuation, the detailed records for stores, supplies, work in progress, finished products, and purchased stock in trade, should be examined and a list prepared of inactive stock accounts, which should be discussed with the company's officials and satisfactory explanations obtained.

(13) The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the balance-sheet. No inventory must be passed which has been marked up to market prices and a profit assumed that is not and may never be realized. If the market is higher than cost, it is permissible to state that fact in a footnote on the balance-sheet.

(14) It may be found that inventories are valued at the average prices of raw materials and supplies on hand at the end of the period. In such cases the averages should be compared with the latest invoices in order to verify the fact that they are not in

excess of the latest prices, and also with the trade papers, when market prices are used, to see that they are not in excess of market values.

(15) Make an independent inspection of the inventory sheets to determine whether or not the quantities are reasonable, and whether they accord in particular instances with the average consumption and average purchases over a fixed period. Abnormally large quantities of stock on hand may be the legitimate result of shrewd foresight in buying in a low market, but may, on the other hand, arise from serious errors in stock taking.

(16) Always attempt to check the totals by the "gross profit test" and compare the percentage of gross profit shown with that of previous years. In a business where the average gross profit remains fairly constant this test is a dependable one, because, if the rate of gross profit is apparently not maintained and the discrepancy can not be satisfactorily accounted for by a rise or fall in the cost of production or of the selling price, the difference will usually be due to errors in stock taking.

(17) In verifying the prices at which the work in progress is included in the inventory, a general examination and test of the cost system in force is the best means of doing this work satisfactorily. In a good cost system little difficulty will be found with the distribution of the raw materials, stores, and payroll, but the distribution of factory overhead cost is one that should receive careful consideration, the main points to be kept in view being:

(*a*) That no selling expenses, interest charges, or administrative expenses are included in the factory overhead cost.

(*b*) That the factory overhead cost is distributed over the various departments, shops, and commodities on a fair and equitable basis.

(18) No profit should be included in the price of finished products or stock in trade. The price list should be examined to see that the cost prices of stock are below the selling prices after allowing for trade discounts, and, if they are not, a reserve should be set up on the balance-sheet for this loss. If the company takes immediate steps to increase the selling price, however, the amount of this reserve may be limited to the loss on goods which may have been sold since the close of the period to the date of the discovery.

(19) In the case of companies manufacturing large contracts it is frequently found necessary to make partial shipments thereof. The question then arises as to whether it is permissible to include the profits on these partial shipments in the profit and loss account. As a matter of fact, it is evident that the actual cost can not be known until the order is completed. It may be estimated that a profit will ultimately be made, yet unforeseen conditions, such as strikes, delays in receiving material, etc., may arise to increase the estimated cost. It is better not to include the profits on partial shipments, but information of this character which may have its influence in the decision of the banker upon a proposed loan may properly be laid before him. Of course, an exception should be made in cases where the profit on the partial shipments largely exceeds the selling price of the balance of the order.

(20) The selling prices for contract work in progress should be ascertained from the contracts, and where it is apparent that there will be a loss on the completed contract a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress.

(21) If a company has discontinued the manufacture of any of its products during the year, the inventory of such products should be carefully scrutinized and, if unsalable, the amount should be written off.

(22) The inventory should be scrutinized to see that no machinery or other material that has been charged to plant or property account is included therein.

(23) Partial deliveries received on account of purchase contracts for material, etc., should be verified by certificates from the contractors, both as to quantities and prices.

(24) Advance payments on account of purchase contracts for future deliveries should never appear in an inventory, but be shown on the balance sheet under a separate heading.

(25) Trade discounts should be deducted from inventory prices, but it is not customary to deduct cash discounts. However, this may be done when it is the trade practice so to do.

(26) While the inventory is being verified, the auditor should ascertain the aggregate sales for the last year. If the turnover has not been rapid, it may be due to a poor stock of goods. Some

business men dislike to sell below cost and would rather accumulate a big stock of old goods than dispose of the old and unseasonable stock at a sacrifice. The usual outcome is that the stock becomes unwieldy and funds are lacking to purchase new goods. The inventory and the gross sales may, therefore, have a direct connection.

(27) It may be well to reiterate that interest, selling expenses, and administrative expenses form no part of the cost of production, and therefore should not be included in the inventory in any shape.

COST OF FIXED PROPERTY

In preparing the leading schedules for the accounts grouped under this heading, such as real estate, buildings, plant, machinery, etc., the balances at the beginning of the period, the additions to or deductions from the accounts during the year, and the balances at the end of the period must be shown.

The total of the balances at the beginning of the period must agree with the cost of property figures given in the balance-sheet at that date, and the balances at the end of the period with the amount shown in the balance-sheet that is being audited. The charges entering into the additions must be verified in detail, and in this connection the following notes are of value:

(1) Authorizations for the expenditure made during the year should be examined, and where the costs of the additions have overrun the sums authorized, inquiries should be made in regard thereto. The authorizations should show the accounts to which the expenditures are chargeable, the amounts thereof, the approvals of the comptroller and manager, and descriptions of the jobs. When the authorizations are not specific as to the work done, the actual additions should, if possible, be inspected.

(2) The auditor should satisfy himself before approving additions that they were made with the object of increasing the earning capacity of the plant, and that they are not of the nature of either renewals or improvements, and in this connection changes in the production and capacity of the plant should receive consideration.

(3) To verify the payroll and store and supply charges to jobs, one or two payroll distribution reports should be examined in

detail, and also one or two storehouse reports. In cases where large purchases have been made from outside parties for capital construction work, the vouchers therefor should be examined and the usual precautions taken to see that they are properly approved for the receipt of materials, prices, etc.

(4) For purchases of real estate the title deeds should be examined, together with the vouchers, and it should be seen that the deeds have been properly recorded.

(5) While it may be considered permissible to make a charge for factory overhead cost to additions to property such as, e. g., time of superintendent and his clerical force employed on construction work, etc., it can not be deemed conservative business practice, inasmuch as the probabilities are that the overhead charges of a plant will not be decreased to any extent even though additions are not under way, and, therefore, the absorption of part of these charges when additions are in progress, has the effect of reducing the operating costs, as compared with months in which no construction work is under way.

(6) Construction work in progress at the end of the fiscal period should be shown in the balance-sheet under the heading of fixed assets and not as part of the inventories. This is important to bear in mind because construction work is not an asset that can be quickly turned into money, while everything in the inventory is supposed to be realizable in cash within a reasonably short time.

(7) The auditor should inquire as to whether any instalments are due on account of construction work in progress which is being carried on by outside parties; and if so, the liabilities for these instalments should be included in the balance-sheet, as they may have a direct bearing on the amount of available cash on hand.

(8) When a company uses leasehold properties the leases should be examined and notes made of the periods covered, so that it may be seen that improvements, etc., on such properties are written off over the periods covered by the leases.

(9) The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are adequate to reflect the deterioration in the value of the fixed properties. If

in his opinion the reserves shown on the balance sheet are insufficient, he should call attention to the matter in his certificate.

(10) Care should be taken to insure that property destroyed by fire or otherwise prematurely put out of service is correctly treated in the books. Any portion of the original charge for such property which is not recoverable through insurance, as salvage or otherwise, and has not been provided for by the depreciation scheme should be written off.

It is to be observed that the foregoing notes are to be applied only to cost of properties incurred during the period under audit. In addition, information may usefully be obtained on broader lines in regard to the composition of the real estate, building, and machinery accounts, and showing what principal property is represented thereby and how the accounts have been built up from year to year for a reasonable time past if not from the inception of the business. The information derived therefrom is valuable only in indicating the progressive policy of the concern, the extent to which it reinvests undivided surplus in its plants, etc. Beyond these facts the banker who is asked for ordinary discounts or short-term loans is not interested; he looks more to the quick assets for his security.

Optional.—When the loan is greater than the quick assets seem to justify the auditor should suggest a reliable verification of the cost of property prior to the period under audit. Such action may become necessary even to the extent of calling for an appraisement by disinterested outside experts.

DEFERRED CHARGES TO OPERATIONS

Under this heading in the balance-sheet are grouped such items as unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc. After the clerical accuracy of the deferred charges has been verified the auditor should satisfy himself that they are properly carried forward to future operations.

Wherever possible, documentary proof must be produced in support of the items carried forward, as, for example, with unexpired insurance the policies must be examined to verify the dates of expiration, the amounts covered, and the proportion of the premiums carried forward; with royalties the agreements must be examined; with experimental charges the vouchers and particulars of the work done must be looked into, etc.

The examination of the deferred charges will usually furnish the auditor with valuable information in regard to the accounts of the company, as, e. g.:

(1) The verification of experimental charges carried forward will generally furnish information as to the production and future policy of the company.

(2) Royalty vouchers will generally furnish a check on the production of mines.

(3) An examination of the insurance policies will show if the properties are mortgaged or covered by lien, and thus be an additional verification of the liability for mortgages on real estate, buildings, etc., shown in the balance-sheeet.

(4) The assets covered by insurance will be ascertained and if any omissions are discovered they should be mentioned.

NOTES AND BILLS PAYABLE

Under this caption appear notes payable and drafts accepted. Schedules should be prepared under the subcaptions, and in columns headed:

Date of making the notes or drafts.
Due dates.
Names of creditors
Collateral hypothecated.
Additional endorsers.
Interest accrued to date of audit.
Notations of renewals (as information of this nature furnishes a guide to the state of the concern's credit).

The schedule must be compared with the notes-payable book and the total of the aggregate must agree with the balance of the ledger account of notes payable.

Statements must be obtained from all banks and brokers with whom the concern does business, showing all notes and drafts discounted or sold by them for the benefit of the concern. These statements when received must be checked against the loans shown on the concern's books and approved in the minutes of the company.

Inasmuch as a note is a negotiable instrument, care must be taken to see that all of those recorded as paid during the year under audit have been properly discharged, and the canceled notes are the best evidence of this fact.

Careful attention should be given to the collateral deposited for loans, and statements as to the existence of such collateral should be obtained from the holders thereof. Such hypothecation of any of the concern's assets should be accounted for on the balance-sheet.

When practicable the auditor might suggest to the client the advisability of drawing notes payable on blanks bound in a book, like a check book, with a stub for each blank, the blank and the stub to bear identical numbers. The officer, or officers, signing the notes could, in such case, initial the stub as a certificate to the amounts, payees, and terms of the notes issued. If this were done, the auditing of bills payable would be greatly facilitated.

ACCOUNTS PAYABLE

A list of balances due on open accounts must be prepared and carefully checked with the ledger accounts, care being taken to see that no open account on the ledger has been omitted from the list. It should be ascertained that the balances represent specific and recent items only. When any account does not appear regular a statement from the creditor should be obtained. If there are many such accounts in dispute, and they amount to so large a sum as to affect appreciably the total of current liabilities, the general cause for the disputes should be inquired into and note made of the matter for the consideration of the banker.

In concerns with modern voucher systems accounts payable are easily verified, as all liabilities are then included in the books when incurred. Care should be taken, however, to see that all goods received on the last day of the fiscal period, as shown by the receiving records, and also all goods that were in transit and belonged to the concern on that date, are included as liabilities, and the corresponding assets included in the inventories. This test is necessary, as an increase in the accounts payable may have a very important bearing on the financial position of the concern if the cash on hand is small.

Monthly expenses outstanding can usually be ascertained by a comparison of the expenses of the last month of the fiscal period with previous months, and those of the year with the previous year. The voucher record should, however, be examined for the months subsequent to the close of the fiscal year, in case any expenses included therein are applicable to the fiscal period under audit.

When a first-class voucher system is not in operation the auditor must take additional precautions to satisfy himself that all liabilities are included in the accounts, among which may be mentioned:

(1) Payments made in the months subsequent to the date of the fiscal period as shown by the cashbook, which should be carefully scrutinized to see that none of them is applicable to the period under review.

(2) The file of bills not vouchered or entered on the books should be examined to see that none of them belongs to the period under audit.

(3) A careful perusal of the minutes of a company may further assist the auditor in determining liabilities.

When a company has large purchase contracts in force for future deliveries they should be examined, for if the contract prices are greater than market prices, it might be necessary to set up a reserve for this loss. Any debit balance due to advance payments on such contracts or to any other cause should be shown on the balance-sheet under a separate heading.

If the business under audit is one where there is any possibility of goods having been received on consignments, and part or all of such goods having been sold without a liability therefor having been shown in the books, the auditor must use all due diligence to cover the point fully. This may readily happen, as consignment accounts are usually treated as memoranda only.

If inquiry develops the fact that goods have been received on consignment, all records in connection therewith should be called for. If the goods have all been sold, the consignor's account should show the full amount due, and if the debt is a current one the amount will appear among accounts payable due to trade creditors. Where only part of the goods have been sold the net proceeds due to the consignors should be shown on the balance-sheet under the caption of "Accounts payable consignors."

As an additional precaution against the omission of liabilities a certificate should be obtained from the proper officer or member of the concern stating that all outstanding liabilities for purchases and expenses have been included in the accounts of the period under review or of former periods. In many cases it is also advisable to obtain a certificate from the president stating that all liabilities for legal claims, infringements of patents, claims for damages, bank loans, etc., have been included, as he may be the only executive officer of the company to know the extent of such obligations.

CONTINGENT LIABILITIES

It is not enough that a balance-sheet shows what must be paid; it should set forth with as much particularity as possible what may have to be paid. It is the duty of an auditor who makes a balance-sheet audit to discover and report upon liabilities of every description, not only liquidated debts but possible debts. The following are the usual forms under which contingent liabilities will be found:

Endorsements.—Inquiry of the officers or partners of the concern should be made as to whether any endorsement of outside paper has been made and as to any security received to protect the concern. Such inquiry should be particularly strict if it is known that any of the officers or partners are interested in other enterprises.

Guaranties.—Similar action should be taken in the matter of guaranties.

Unfulfilled contracts.—Contracts to accept the delivery of goods contracted for before the date of the balance-sheet, may call for the payment of large sums of money within a short time. In the case of raw materials, for a manufacturer, this might be a perfectly legitimate reason for seeking a temporary loan pending production and sale, but for a merchant whose balance-sheet shows a large stock of goods on hand, it might indicate a real liability impending with assets of a doubtful character to offset it. In every audit, therefore, the auditor should call for copies of all orders for future delivery, and if such orders call for stock in excess of the current and reasonable prospective demand, mention should be made on the balance-sheet and a report submitted, the details depending upon the circumstances of each particular case.

Items other than those arising from the specific hypothecation of current assets to be listed under item 20 should appear as a footnote on the liability side of the balance-sheet, the total amounts being stated for each subheading and such additional report made as will convey clear information to the banker.

ACCRUED LIABILITIES

Under this caption are grouped such items as interest, taxes, wages, etc., which have accrued to the end of the period under audit, but are not due and payable until a later date. The verification of such items can be accurately made from the books and records. Special attention may be directed to the following:

Interest payable.—Many of the liabilities which appear on a balance-sheet carry interest. Such items as bonds and notes payable are obvious, but the auditor should also consider the possibility of accounts also bearing interest, as enough book accounts, when past due, do bear interest to warrant inquiry being made. Loan accounts of partners and officers of corporations almost invariably bear interest; also judgments, overdue taxes, and other liens.

Taxes.—The amount of accrued State and local taxes can be ascertained from an examination of the latest tax receipts; though in some cases, as the period for which the taxes are paid is not shown on the face of the receipt, it may be necessary to make inquiries of the proper taxing authorities as to the period covered.

Under the federal income tax law a tax of 2 per cent is imposed upon the net profits of a corporation, which must be paid even if the corporation is dissolved before the end of the year during which the tax is imposed. As the tax is specifically based upon the net profits of a particular period, although payable some months thereafter, the tax accrues throughout the specified period, and if a net profit is disclosed upon the closing of the books at any date during the year, a reserve of 2 per cent. must be shown on the balance-sheet as an accrued tax.

Wages.—Where the date of the balance-sheet does not coincide with the date to which the last payroll of the period under audit has been calculated, the amount accrued to the date of the balance-sheet must be ascertained and entered as a liability, unless such amount is trifling. It will suffice to take the proportion of a full week's payroll (six days) without reference to possible daily variations.

Water rates, etc.—Where bills for such expenses as water, gas, etc., are not rendered monthly, the auditor must enter the accrual of the proper proportion since the last bill as a liability.

Traveling expenses and commissions.—It is important to note whether the accounts of all traveling salesmen have been received and entered before the books are closed. The auditor should secure a list, and if any report was not so entered, provision should be made for it unless the amount is likely to be trifling.

Ample provision should be made for all commissions eventually payable on sales which have been billed to customers. As commissions are frequently not payable to salesmen until the sales have been collected from customers, accrued commissions are often omitted from the books. As they must, however, be paid out of the proceeds of the sales on which the full profit has already been taken into the accounts, they should be set up as an accrued liability.

Legal expense.—All concerns have more or less litigation. Before the books are closed the lawyers should be requested to send in a bill to date. If one is not found, the auditor should ascertain the amount, if any, probably due and set it up as an accrued liability.

Damages.—If the concern is insured against liability for damages to employees or the public, a proportion of the premiums paid in advance for the unexpired time covered by the insurance will appear in "Deferred charges." But there may be claims or suits for other damages not covered by insurance, and where the auditor finds any evidence which leads him to suspect there may be liability of this nature he should insist upon being informed of all the facts. He can then form an opinion as to the amount that should be set up as an accrued liability, or, if the outcome is uncertain, as a reserve against possible loss.

BONDED AND MORTGAGE DEBT

A copy of the mortgages must be examined and the terms thereof noted. The amount of bonds registered, issued, and in treasury, rate of interest, and duration of the bonds, should be shown on the face of the balance-sheet. A certificate should be obtained from the trust company certifying the amount of bonds outstanding, etc., as verification of the liability stated in the balance-sheet. The interest on the bonds outstanding, shown in the balance-sheet, should be calculated and reconciled with the interest on bonds, as shown in the profit and loss account.

Sinking-fund provisions in mortgages should be carefully noted and care should be taken to see that they are provided for in the accounts of the company, and any default noted in the balance-sheet.

Bonds redeemed during the period or previously should be examined to see that they have been properly canceled, or, if they have been destroyed, a cremation certificate should be obtained from the trustees.

Mortgages sometimes stipulate that the current assets must be maintained at a certain amount in excess of the current liabilities, and the auditor must give due consideration to such matters and any other stipulation in regard to the accounts, or any audit thereof, that may be referred to in the trust deed, and see that they have been complied with.

Mortgages.—As a mortgage derives its chief value from the fact that upon registry it becomes a lien, the auditor should verify the existence of such an obligation by inspecting the public records, not only with reference to such as may be found on the company's books, but also any that may still appear on the public records as unsatisfied. If the auditor lacks the necessary facilities for making a search it will be worth his while to arrange with a local lawyer or title company whereby, for a small fee, any mortgages or judgments entered against the concern under audit will be reported to him.

In any event the auditor must verify the amount as recorded in the account, the rate, the due date, and the property covered thereby.

It should be borne in mind that a payment on account of a mortgage must be recorded or the entire amount will remain as an encumbrance on the property. Therefore, if payments on account appear, the auditor should ascertain if they have been so recorded; if not the fact should be noted on the balance-sheet.

Judgments.—The same procedure should be followed in verifying judgments as in verifying mortgages. As many business men consider that the entry of an invoice is an admission of. liability, and will not permit the entry of a claim which they propose to fight, it is sometimes difficult for an auditor to find any evidence of such liens. Even admitting the fact, they may still refuse to allow the judgment to be entered on the books as a liability, in which case it is proper for the auditor to include it as a footnote on the balance-sheet as a contingent liability.

Unpaid interest.—When considering the matter of liens it should be noted that interest unpaid is a lien as well as unpaid principal, so where the auditor finds evidence of interest on liens being in default, he should add it to the principal in each case.

CAPITAL STOCK

As a rule trust companies are the transfer agents for the capital stock of large corporations and for verification purposes it is sufficient to obtain letters from them certifying to the capital stock outstanding.

Where companies issue their own stock, the stock registers and stock certificate books should be examined and compared with the lists of outstanding stockholders.

On the balance-sheet each class, if more than one, of stock must be stated, giving amount authorized, issued, and in treasury, if any. In the case of companies with cumulative preferred stocks outstanding a note must be made in the balance-sheet of the dividends accrued but not yet declared.

If stock has been sold on the instalment plan, the auditor should ascertain that the calls have been properly met and whether any are in arrears. If special terms have been extended to any stockholder, approval of the board of directors is necessary and the minutes should be examined accordingly.

If any stock has been sold during the period under audit, the auditor should verify the proceeds of the sales.

SURPLUS

The auditor should give consideration to the surplus at the beginning of the period. This item represents the accumulated profits prior to the beginning of the fiscal period under review, and should be compared with the surplus shown on the balance-sheet of the previous year, and with the ledger account, to see that it corresponds, and if it does not, a reconciliation statement should be prepared giving full details of the differences.

PROFIT AND LOSS

The auditor should obtain the profit and loss statement for three years, at least, including the period under audit, and after verifying them by comparison with the ledger account, prepare a statement in comparative form. This comparison will furnish valuable information to the banker as to the past progress of the concern under audit.

A satisfactory form of profit and loss account is annexed hereto, but any other form giving substantially similar information is acceptable.

While it would be impracticable in an ordinary balance-sheet audit, and, at the same time, somewhat useless to make a detailed check of all the transactions entering into the composition of the profit and loss account, there are certain main principles to be kept in view which are briefly outlined below:

SALES

Whenever it is possible, the quantities sold should be reconciled with the inventory on hand at the beginning of the period, plus the production, or purchases, during the period, less the inventory on hand at end of the period.

Where a good cost and accounting system is in force, the sales records will very probably be in good shape, but nevertheless, the auditor should satisfy himself from the shipping records that the sales books were closed on the last day of the fiscal year, and that no goods shipped after that date are included in the transactions.

When an audit is being made for the first time, the auditor should satisfy himself that the sales at the beginning of the period were recorded in accordance with the dates of shipments. Such verifications can be made conveniently by a direct comparison of the shipping memoranda with the invoices billed.

Allowances to customers for trade discounts, outward freights, reductions in prices, etc., should be deducted from the sales in the profit and loss account, as the amount of net sales is the only figure of interest to the bankers.

The future bookings at the close of the fiscal year should be looked into, as a comparison of orders on hand with corresponding periods of other years furnishes the bankers with an idea of the concern's business outlook.

COST OF SALES

The inventory at the beginning of the period, plus purchases during the period, less inventory at the end of period, gives the cost of sales. In a manufacturing concern the factory cost of production takes the place of purchases. These items will have already been verified in auditing the balance-sheet, but nevertheless care should be taken to see that this heading has not been made a dumping ground for charges which would be more properly embraced under the heading of special charges. The composition of the items entering into the cost of sales should be traced in totals into the cost ledgers or accounts.

GROSS PROFIT ON SALES

This is obtained by deducting the cost of sales from the net sales. The ratio of gross profits to net sales should be calculated and compared.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Under these general headings should be set down the expenses itemized to correspond with the titles of the ledger accounts kept in each division. In checking the totals of each account with the statement for the period under audit, special attention to credits in these accounts should be given to see that none have been made for the sale of capital assets and for other items which should not appear in expense accounts. The percentages of the totals of each division and of the aggregate total to net sales should be calculated for each year for comparison.

NET PROFIT ON SALES

This is obtained by deducting the aggregate total of the selling, general, and administrative expenses from the gross profit on sales, and shows the net earnings of the concern on its real business. Ratio to sales should be calculated for each year for comparison.

OTHER INCOME

Under this heading is embraced any income that may be derived from sources outside of sales, such as income from investments, interest, discounts, etc. Schedules should be prepared of each item, and the auditor should satisfy himself of their accuracy and of the propriety of including them as income.

DEDUCTIONS FROM INCOME

Under this heading are grouped such items as interest on bonded debt, interest on notes payable, etc. The same procedure of verification as in the case of other income should be followed.

NET INCOME—PROFIT AND LOSS

Adding other income to gross income and deducting deductions from income gives the net income or profit and loss for the period, which is the amount that should be carried to the surplus account.

SURPLUS ADDITIONS AND DEDUCTIONS

Items of unusual or extraordinary profit which do not belong strictly to the period under audit, or can not be said to be the legitimate result of the ordinary transactions of the concern, should be entered here and verified with the surplus account. Similarly, deductions should be treated. Also dividends declared should be entered in the surplus account and as an item under this caption, inasmuch as it is the usual custom to declare dividends "from net earnings and surplus." After adding special credits to and deducting special charges from the net income we have the total profit and loss for the whole period from all sources which, added to the surplus balance at the beginning of the period, gives us the surplus at the end of the period, which should agree with the surplus as stated on the balance-sheet.

GENERAL

These instructions cover audits of small or medium-sized concerns. In large concerns having, for instance, tens of thousands of accounts or notes receivable, the detail procedure suggested would be impracticable, and internal check should make it unnecessary. In such cases only tests can be made, but the auditor must always be prepared to justify his departure from a complete programme by showing that the purposes sought to be accomplished thereby have been adequately effected by his work.

Any extensive clerical work, such as preparations of lists of notes receivable, etc., should be performed by the client's staff, so as to avoid unnecessary employment of professional staff in merely clerical work and consequent undue expense.

FORM OF CERTIFICATE

The balance-sheet and certificate should be connected with the accounts in such a way as to ensure that they shall be used only conjointly. This rule applies also to any report or memorandum containing any reservations as to the auditor's responsibility; any qualification as to the accounts, or any reference to facts materially affecting the financial position of the concern.

The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner.

If the auditor is satisfied that his audit has been complete and conforms to the general instructions of the Federal Reserve Board, and that the balance-sheet and profit and loss statement are correct, or that any minor qualifications are fully covered by the footnotes on the balance sheet, the following form is proper:

> I have audited the accounts of Blank & Co. for the period from ....to.............and I certify that the above balance-sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at.............and the results of its operations for the period.
>
> (Signed) A. B. C.

[FORM FOR PROFIT AND LOSS ACCOUNT.]

Comparative statement of profit and loss for three years ending......19 .

	Year ending—		
	19—	19—	19—
Gross sales	$	$	$
Less outward freight, allowances, and returns			
Net sales			
Inventory beginning of year			
Purchases, net			
Less inventory end of year			
Cost of sales			
Gross profit on sales			
Selling expenses (itemized to correspond with ledger accounts kept)			
Total selling expense			
General expenses (itemized to correspond with ledger accounts kept)			
Total general expense			
Administrative expenses (itemized to correspond with ledger accounts kept)			
Total administrative expense			
Total expenses			
Net profit on sales			
Other income:			
Income from investments			
Interest on notes receivable, etc			
Gross income			
Deductions from income:			
Interest on bonded debt			
Interest on notes payable			
Total deductions			
Net income—profit and loss			
Add special credits to profit and loss			
Deduct special charges to profit and loss			
Profit and loss for period			
Surplus beginning of period			
Dividends paid			
Surplus ending of period			

[FORM OF BALANCE SHEET.]

ASSETS.

Cash:			
1a. Cash on hand—currency and coin		....	
1b. Cash in bank		....	....
Notes and accounts receivable:			
3. Notes receivable of customers on hand (not past due)		....	
5. Notes receivable discounted or sold with indorsement or guaranty		....	
7. Accounts receivable, customers (not past due)		....	
9. Notes receivable, customers, past due (cash value, $..)		....	
11. Accounts receivable, customers, past due (cash value, $....)		....	
Less:			
13. Provisions for bad debts	......		
15. Provisions for discounts, freights, allowances, etc	......	....	....
Inventories:			
17. Raw material on hand		....	
19. Goods in process		....	
21. Uncompleted contracts	......		
Less payments on account thereof	......	....	
23. Finished goods on hand		....	....
Other quick assets (describe fully):			
....		....	
....		....	....
Total quick assets (excluding all investments)		....	....
Securities:			
25. Securities readily marketable and salable without impairing the business		....	
27. Notes given by officers, stockholders, or employees		....	
29. Accounts due from officers, stockholders, or employees		....	....
Total current assets		....	....
Fixed assets:			
31. Land used for plant		....	
33. Buildings used for plant		....	
35. Machinery		....	
37. Tools and plant equipment		....	
39. Patterns and drawings		....	
41. Office furniture and fixtures		....	
43. Other fixed assets, if any (describe fully)		....	
....		....	
		....	
Less:			
45. Reserves for depreciation		....	....
Total fixed assets		....	
Deferred charges:			
47. Prepaid expenses, interest, insurance, taxes, etc		....	....
Other assets (49)		....	....
Total assets		....	....

[FORM OF BALANCE SHEET.]

LIABILITIES.

Bills, notes and accounts payable:		
Unsecured bills and notes—		
2. Acceptances made for merchandise or raw material purchased	....	
4. Notes given for merchandise or raw material purchased	....	
6. Notes given to banks for money borrowed........	....	
8. Notes sold through brokers........	....	
10. Notes given for machinery, additions to plant, etc....	....	
12. Notes due to stockholders, officers, or employees....	....	
		....
Unsecured accounts—		
14. Accounts payable for purchase (not yet due)........	....	
16. Accounts payable for purchases (past due)........	....	
18. Accounts payable to stockholders, officers, or employees	....	
		....
Secured liabilities—		
20a. Notes receivable discounted or sold with indorsement or guaranty (contra)........	....	
20b. Customers' accounts discounted or assigned (contra).	....	
20c. Obligations secured by liens on inventories........	....	
20d. Obligations secured by securities deposited as collateral	....	
		....
22. Accrued liabilities (interest, taxes, wages, etc.)......	....	....
Other current liabilities (describe fully):		
....	....	
....	....	
		....
Total current liabilities........	....	....
Fixed liabilities:		
24. Mortgage on plant (due date......)........	....	
26. Mortgage on other real estate (due date......)........	....	
28. Chattel mortgage on machinery or equipment (due date......)	....	
30. Bonded debt (due date......)........	....	
		....
32. Other fixed liabilities (describe fully):		
....	....	
....	....	
		....
Total liabilities........	....	....
Net worth:		
34. If a corporation—		
(a) Preferred stock (less stock in treasury)........	....	
(b) Common stock (less stock in treasury)........	....	
(c) Surplus and undivided profits........	....	
Less—		
(d) Book value of goodwill........		
(e) Deficit		
	....	
		....
36. If an individual or partnership—		
(a) Capital	....	
(b) Undistributed profits or deficit........	....	
Total	....	....

Excess Profits Tax in Great Britain

By James Wright, C.A.

BASIS OF TAX

The excess profits tax is levied upon the profits of all business concerns in Great Britain and Ireland. It was at first intended that the tax should be one upon war profits, but parliament saw the impossibility of defining exactly what war profits were. This proposition was therefore abandoned and it became a war tax on profits. As can be understood, certain industries benefited much more than others owing to war demands, and it was only fair that all industries should bear their proper share of the cost.

PRE-WAR PROFITS STANDARD

Under the income tax laws the profits for any one year are based upon the average of the three preceding years. For example, the average profit of the years 1914/15/16 represents the profit assessed for the year 1917. It was at first suggested, when the excess tax was proposed, that this should be the basis of the pre-war profits standard, but ultimately a concession was made to the taxpayer by which he was enabled to take the best two out of three pre-war years. This now represents the profits standard or datum line by which profits for war periods are compared, with the following exceptions:

Where it is found that the profits do not amount to 6 per cent. of the capital in the case of companies and 7 per cent. in the case of private concerns, these percentage amounts may be claimed in lieu of the profits standard.

Under the act, a board of referees was constituted to which the taxpayer could appeal in the event of his considering that the percentages above mentioned were inadequate. For example, a business carried on in a foreign country or under speculative conditions would necessarily be entitled to a higher rate, and this the board of referees has power to grant. For example, the rate for oil producing in California was fixed at 8½ per cent. and 9½ per cent. respectively in the case of companies and private concerns.

In connection with businesses which were in a depressed state prior to the war, the taxpayer may take as his profits standard the average profits of any four out of the last six pre-war trade years, where both of the following conditions apply:

(1) The commissioners of inland revenue must be satisfied that the three last pre-war trade years were years of abnormal depression;

(2) To constitute a state of depression the average profits of the three last pre-war trade years must be at least 25 per cent. lower than the average profits of the three years preceding them.

SET OFF OF LOSSES AGAINST PROFITS

If there is a loss in the first accounting period, this may be set off against the profit in the second and subsequent accounting periods and duty is payable on the net profit. It, therefore, follows that the assessment is upon the net profit for the whole war period.

RENEWALS AND REPAIRS

Where it is found impossible to carry out the execution of repairs or renewals due to the war, the commissioners of inland revenue may, on the taxpayer's application, allow a modification of the rules to meet the conditions.

Where there has been exceptional depreciation or obsolescence of assets employed in the business, the commissioners may allow such modifications as they think necessary to meet the case.

In other cases, plants which have been provided to meet war conditions, and may not be wanted after the war, may, by arrangement with the commissioners, be written off within a certain period or a post-war value may be agreed upon, the balance to be written off in the war period.

REMUNERATION OF MANAGING DIRECTORS, ETC.

Under the act, remuneration allowed to persons concerned in the management of a business for the war period may not exceed the corresponding amount allowed in the last pre-war trade year. This does not prevent a concern from paying increased amounts in respect of special services to those concerned in the management, but for the computation of excess profits, such additional remuneration will be disallowed. One can see that this restriction, from the government point of view, is quite sound.

COMMISSIONS TO MANAGERS, ETC.

Several decisions have been given recently in the courts regarding the payment of commission to managers. The decisions have mostly been in the lower courts, but so far the decisions have been that a manager is entitled to his commission on profits before excess profits duty is charged. This may not appear very equitable, as the increased profits are in many cases undoubtedly due to the war and consequently the excess profits duty should be reckoned as an expense before the commission on the net profit is ascertained. Against this a manager might claim that, owing to war conditions, he has much more work to do and is, therefore, entitled to the commission on the increased profits.

INCOME TAX AND EXCESS PROFITS DUTY

In computing liability to excess profits duty, no allowance is to be made on account of any payment of excess profits duty or income tax. In other words, if these are included as an expense in the accounts, they must be added back to profits.

In computing liability to income tax an allowance is made in respect of excess profits duty. In other words, it can be charged as an expense.

NEW BUSINESS

Where there have been two pre-war trade years but not three, the pre-war standard of profit can be taken either as the average profits of the two years or the profit of the last year at the option of the taxpayer.

Where there has been one pre-war trade year but not two, the pre-war standard of profit can be taken as the one year's trading.

Where there has not been one pre-war trade year, the percentage standard must be adopted.

STATUTORY ALLOWANCE

An allowance of £200 per annum is made from the profits in order that the treasury may not be troubled with small concerns. If the excess profits do not come to this amount, they are exempt from taxation. An abatement is made in every case of this amount in addition to the pre-war profits standard.

DUTY PAYABLE

For the first year the duty payable was 50 per cent of the excess profits and for the second year and onwards 60 per cent. The latter is the present rate which may be increased when the budget is submitted.*

ALLOWANCE IN RESPECT OF INCREASE OF CAPITAL

If the amount of capital employed in a business for the war period exceeded that of the pre-war period, allowance is made in respect of the excess by granting 6 per cent. in the case of companies and 7 per cent. in the case of private concerns as a deduction. If the capital were correspondingly reduced, a similar charge is made against the taxpayer.

CAPITAL

The capital employed in a business compared with the capital employed for the pre-war period is reckoned to be a net surplus of real assets over real liabilities compared with the pre-war period.

It is to be noted that the capital is taken at the beginning of the pre-war profits period and accounting period, not at the end.

In the computation of the capital, goodwill is, under the act, expressly excluded.

Where a business has money invested outside the business, and not required for the business, in the computation of capital the value of these investments requires to be struck out. The corresponding income from the investments is deducted from the profits. The purpose of this is to arrive at purely trade profits.

EXEMPTIONS

The following are not subject to excess profits duty:

(1) Farming and husbandry;

(2) Offices or employments;

(3) Professions where profits are dependent mainly on personal qualifications and require little or no capital.

GENERAL

The foregoing is a short resume of the principal points in the practical working of the act, but reference must be made to the

*Since this article was written, the rate, I understand, has been increased from 60 per cent. to 80 per cent.

act itself for the many rules and exceptions which need not be discussed in a memorandum of this description.

Annexed will be found a typical return of excess profits which will show clearly the working out of the principles stated above:

Appendix I.

EXCESS PROFITS DUTY RETURN

SUMMARY OF PROFITS

	31st May, 1915	31st May, 1916
Profit for accounting period.....	£5,022: —:—	£53,706: —:—
Less		
Allowance in respect of increase of capital..................	487: —:—	489: —:—
See appendix II.		
	£4,535: —:—	£53,217: —:—
Pre-war profits standard		
Year to 31st May, 1913..£15,775: —:—		
Year to 31st May 1914.. 14,399: —:—		....
£30,174: —:—		
Average	15,087: —:—	15,087: —:—
	£10,552: —:—	£38,130: —:—
Deduct		
Statutory allowance............	200: —:—	200: —:—
Assessable excess profits.......	£10,752: —:—	£37,930: —:—
	50%	60%
Duty payable.......—..........	£5,376: —:—	£22,758: —:

SUMMARY OF DUTY

1916 Duty payable.......................	£22,758
1915 " " credit..................	5,376
Net duty payable..................	£17,382

Appendix II.

ALLOWANCE IN RESPECT OF INCREASE OF CAPITAL

		31st May, 1914	31st May, 1915
Capital at beginning of accounting period		£44,909: —:—	£44,942: —:—
Per appendix III.			
Capital for pre-war period			
31st May, 1912	£35,645: —:—		
31st May, 1913	37,944: —:—		
	£73,589: —:—		
Average		36,795: —:—	36,795: —:—
Increase of capital		£8,114: —:—	£8,147: —:—
Interest thereon at statutory rate 6%		£487: —:—	£489: —:—

Carried to appendix I.

Appendix III.

STATEMENT OF CAPITAL

	31st May, 1912	1913	1914	1915
ASSETS				
Buildings	£3,000.	£3,000.	£3,000.	£3,000.
Machinery and plant	7,040.	7,092.	7,534.	8,460.
Stock in trade	34,057.	33,963.	38,484.	28,868.
Sundry debtors	3,874.	7,163.	4,776.	8,584.
Bank balances	300.	4,988.	577.	2,747.
Cash in hand	69.	89.	77.	68.
Total	£48,340.	£56,295.	£54,448.	£51,727
LIABILITIES				
Private loans	£5,000.	£5,000.	£2,500.	£2,500.
Trade creditors	4,838.	494.	327.	593.
Dividends payable, etc.	2,857.	12,857.	6,712.	3,692.
Total	£12,695.	£18,351.	£9,539.	£6,785.
CAPITAL EMPLOYED	£35,645.	£37,944.	£44,909.	£44,942.

Mis-Stated Current Assets

By A. S. Fedde, C. P. A.

It is fairly well understood that values as appearing on a balance-sheet are to a considerable extent the result of estimate and opinion, but the general idea is that this condition is primarily attached to the figures stated of fixed assets and the figures related thereto in the estimated provisions for depreciation—also the estimates which enter into the apportioning of betterment work between additions and renewals. That such estimates should be accurate is of course important, and especially as they have a bearing on the statement of profits.

Current assets, however, are too often looked upon as being absolutely statements of fact, as though all the items were the equivalent of so much cash. The truth is that there is quite as much room for the expression of opinion in the statement of current as of fixed assets; not only that, but many items under the former heading are often grossly mis-stated, at times quite innocently, but sometimes with full knowledge. The innocently incorrect statement may be quite as damaging as one which is deliberately mis-stated.

Financial statements are of interest to several classes of people, but the groups of assets and liabilities known as "current" are of especial interest to the creditor class. To banks it is of vital moment that the items which they scrutinize to judge of the probability of their realization in time to meet maturing liabilities should be correctly stated; but, without an intimate knowledge of the composition of the various items, it is unsafe to place reliance upon them as available for meeting obligations. This extends even to the item of "cash."

This will appear from a consideration of the make-up of the items as sometimes found by accountants in the course of their auditing work.

First, take the item shown as cash in banks and on hand. In some instances cheques drawn and mailed prior to the date of the statement, resulting in an actual overdraft of the bank balance, are written back to the extent of the uncleared cheques, and stated as cash on one side and accounts payable on the other. This is wrong, as the authorizations for the bank to pay certain sums have gone out and the balance of cash available has been reduced thereby. Furthermore, the payment of bills requiring the cash to be drawn so closely as to necessitate borrowing from expected receipts indicates pretty clearly a condition where claims by creditors are pressing. A peculiar instance was seen not long ago, where actual disbursements over a period of a year, amounting to thousands of dollars, were omitted from entry in the books of account, but carried as part of the cash balance, on the ground that the payments were advances to a partner for the purpose of helping a relative who was in business difficulties, and the partner did not wish the sums charged to him, as he expected to replace the cash when his relative had paid him. So far from being cash, this was not even a good account receivable, but a withdrawal of capital.

Miscellaneous items of intrinsic value are at times stated as cash—for example, bar gold which is to be used in manufacturing. The proper location of this is under inventory, as there is no intention of using it in any other way than as raw material.

A common practice is to include in cash, items advanced to salesmen, branch selling offices, traveling repairmen, etc. In a large company these advances will be considerable, and, in my opinion, would preferably be included as working assets. They are available for the conduct of a certain part of the business, but certainly not available for meeting the liabilities shown on the books. Such funds should be classified together with unexpired insurance, prepaid interest and other deferred charges to operating.

Accounts and notes receivable, when not accompanied by explanatory memoranda, are presumed to be debts due to the concern, arising in the ordinary course of business. Items which are often erroneously combined with the figures of balances due from customers are the personal accounts of partners or officers—the latter more frequently in close corporations, where the officers are majority holders of stock.

The matter of opinion enters to an appreciable extent into the values stated for receivable items, through the estimate of the provision necessary for non-realization of accounts. Where the business is large and has been carried on for a number of years, the percentage of bad debts to sales in previous statements of income may furnish an index to the adequacy of the reserve, if business conditions are normal, and if bad debts have been written off when ascertained to be uncollectible.

Advances to affiliated companies should never be combined with accounts receivable of trade customers. Even when shown as a separate item among the current assets, it should be ascertained whether they are balances actually collected from time to time or the advances are more of a permanent nature. In the latter case the item does not belong under current assets at all.

Inventories could be made the subject of a book; only some peculiar phases will be mentioned here. The matter of opinion is of course present in providing for deteriorated or obsolete stock, and one of the most important duties of the auditor is to see that inventories, for which no reserve has been provided, are constituted only of current and usable stock.

Where a cost system is employed, the absorption of expense is reflected in the inventory values, and it should be seen, if amounts in excess of actual expenses have been absorbed, that the portion thereof remaining in the inventory is deducted or provided for by a reserve. The same holds true where the system provides for the inclusion of selling expenses and perhaps interest. The inclusion of such items places fictitious costs on the inventories in the balance-sheet, through the overstatement of finished goods as well as goods in process. Even though inventories as shown may be fully realizable, they are incorrectly stated, due to part of the profit being anticipated.

Some inquiry on the part of a prospective creditor would be prudent, as to the length of time necessary to realize on the inventory in the ordinary course of business. In some lines it is over a year before raw materials are realized in cash, owing to the time necessary to season the raw materials, combined with time of manufacturing and seasoning the finished product, and long terms of credit thereupon being given to customers. Obviously, a banker extending ninety day credit cannot count on such an asset for the meeting of his note.

Apart from the old-time merchant who included his furniture, fixtures, horses, wagons and machinery as "inventory," there are businesses which have a class of merchandise which in some instances is used as part of their equipment and in other instances is partly for sale. If some legislators have their way, brewers' containers will be eliminated from the list, but there are many other instances where containers of some substance, or goods not intended to be sold, are inventoried when on hand and are charged to customers' accounts when shipped, though in neither case are the items expected to be realized in cash. Such items when charged to customers should be credited to a special account to be deducted in a balance-sheet from the accounts receivable, and the cost thereof should be added to the inventory of the same class of goods. Such inventory should be shown under fixed assets as part of the equipment for doing business, and not under current assets.

Accounts and notes payable, including accruals of periodical expenses, are properly subject to the same careful consideration as the current assets, in order that one may arrive at a clear perspective of the net balance of the latter. Ascertaining as far as possible that all liabilities are included is naturally of first importance, but it is also important to ascertain if liabilities are overdue. There have been instances where loans from the bank have been obtained just prior to closing and, though accounts to a great extent were overdue, a large balance of the cash was permitted to remain in the bank over the closing date. Noting such a condition in the cash, the natural inference would be that accounts payable were not yet due and that the concern was paying its obligations promptly.

Contingent liabilities may require the use of assets for their liquidation, dependent upon future conditions. A contingent liability, as to which I find no inquiry on the blanks furnished by banks, is that of liability upon contracts. This contingent liability will in the ordinary course become an actual liability, whereas it is the unusual situation that turns a discounted note into an actual liability. Contracts for future purchase of materials may be of such volume as to make any prospective lender pause and consider—and they may have been made under such conditions that at the balance-sheet date a loss is already in sight.

Some bank forms for balance-sheet contain as the last item following capital stock and surplus the item on a single line "reserves," and no provision appears for deducting any reserves from the assets, or for stating them as true liabilities. In this form the item is evidently considered as contingent or surplus reserves. Surplus reserves are only such as are set aside out of surplus, in order to designate the specific purpose for which such portions of surplus are to be used, whereas reserves set up to provide for valuing as nearly as possible an asset, or for writing off a portion of an asset cost, should be entered as a deduction in the statement of the assets to which they apply. Some prefer to state them on the liability side of the balance-sheet; but the main point, after all, is not to state such reserves as part of the capital employed. They are quite the reverse, being a reduction of the capital employed in the business, and, if applicable as a provision for bad debts, obsolete inventories or accruing liabilities, their consideration is important as bearing upon the values of the current assets and the relation of current assets to current liabilities.

Public Accountants and Industrial Preparedness

By C. C. Waters

Modern war, as H. G. Wells points out, can be waged only by a great industrial nation. War has become a highly organized industry which must have the integrated force of a great state behind it. The machine gun at the front is only one part of the industrial organization which is manufacturing shells and delivering them to the ultimate consumer in the opposing trenches. Every gun and every aeroplane must be supported by a squad of trained mechanics. The whole process of supplying ammunition, repairing machinery, transporting and feeding gunners and bomb throwers is one industry. Any lack of efficiency, any friction, any wasted effort in the whole chain must be paid for by the men in the trenches. A blunder which costs one life out there is inexcusable.

Initiative, enterprise and imagination as well as mechanical and technical skill are demanded from everyone in the organization. The man behind the gun, the oiler at the gun carriage, the porter loading shells, the girl in the munition factory—these are privates in the new industrial army. If our American tradition holds we can fill these positions with those who will show the moral qualities and the skill needed for the job. The big problem for democracy will be to find the foremen, the superintendents, the executives who will organize and integrate this industry called making war. The industrial leaders of proven fitness are needed at their present posts and must not be transferred except as that can be done without disturbing the whole industrial scheme of things. Where can America turn for men who have the mental vision and are trained and equipped to undertake the work of organizing the industrial army?

If the accounting profession had lived up to its promise of twenty years ago, it would by now have developed a corps of trained men, mobile and adaptable for just this work. In such a crisis as this the accountant is led to undertake a little self-examination to see if he has done his part in the campaign of preparedness.

In the city of Boston there are perhaps five hundred men who are now practising public accountants or who have been in the employ of public accountants. These men have had an opportunity to study modern industrial organization in a variety of businesses. If they have lifted their eyes from the columns they were footing or the postings they were checking they have had a splendid opportunity to form opinions as to how industry should be or should not be administered.

These men, and the few thousand like them in other cities of the United States have consumed a tremendous output of correspondence school and business institute literature. They are as a rule keen young men anxious to fit themselves for administrative posts. Many of them have been called to such posts and are now organizing and directing the management of corporations. The remainder are going from one corporation to another, examining methods, criticising policies, making constructive suggestions. Here is a group of men who are fitted by experience and who, as professional men, should have the initiative and vision to play their part in the organization of the country's industries for peace or war. They are furthermore a fluid and mobile group. They could turn to this work without disrupting any one branch of industry.

It is very evident that accountants have not created that kind of an impression upon their communities which will cause the country to turn to them unanimously. This may be the fault of the communities. But it is possible that the accountants are themselves to blame. They have apparently failed to appreciate the need of securing the confidence of a democracy by public spirited service.

Within the past fifteen years there have appeared striking evidences of a change in the attitude of many business and professional men toward their work. Certain corporations are thinking and advertising in terms of service as well as profits. But in no case is this change more evident than among physicians who have taken up preventive medicine. The old style physicians were a caste, hedged in with an elaborate ethical code. What a physician did with a given case was nobody's business so long as he observed certain rules of the trade. The new school breaks through this code to give advice and instruction on public health which will tend to reduce the fees of fellow physicians. The doctors of the new school have seen a vision of public service. They have done much to restore the medical profession to the position of respect and honor which it had been rapidly losing.

In spite of this tendency in other professions, accountants have kept the point of view of the business man of the nineties. They still think in terms of profits instead of service. There are exceptions, but the main trend of thought among practising accountants is toward exclusiveness and professional ethics rather than public service and general development. The objects of the Institute of Accountants, as stated in its constitution, fail to express any high ideals of social service. In fact, the one avowed purpose of the institute is to protect accountants' rights. Very little has been said about the need of preparing for new and larger duties.

This is of course perfectly natural. Any profession, especially a new and growing one, needs to protect itself against fakirs. But there is ground for suspicion that in consolidating its present position and digging in to protect its rights, the accounting profession has failed even to try for the position it should have won.

It is so evident in time of national peril that there are bigger things than profits that it is surprising how easily we lose sight of that fact at other times. We have suddenly been awakened to perceive that, while the accountant has been qualifying his certificate and trimming his sails to avoid hurting his clients' feelings, a thousand evils have been permitted to develop in the industrial life of the nation without any efficient protest. And now, when we come to industrial preparation for war, these evils, which seemed to be nobody's business a year ago, are sources of danger to the country.

The arraignment of the public accountant at the bar of the social consciousness runs as follows:—He has been too busy making himself useful to the money lender to protest sufficiently against anti-social methods and policies in business. He has failed to develop himself and train his juniors to assume the social duties which he is technically equipped to perform. He has failed to do his duty as a citizen in the field of public finance. He has sidestepped the great industrial issues. He has lost his opportunity to gain the confidence of labor. He has been discredited as an impartial specialist along with other experts who have stooped to partisanship. He has lacked vision. He is now unprepared to do what he should be able to do for his country.

Manhood is not necessarily disclosed in a written examination. A profession which claims leadership in a democracy must attract men of courage and vision. It is not enough to exclude incompetents. Men who have the qualities which make for leadership toward fields of greater service must be sought. And when they are found they will be needed in the profession and should not be discouraged and driven, too early in their development, into specialized positions.

The fate of the corporation lawyer is an example full of warning for the accountant. There is no class in the community more thoroughly discredited in the eyes of the average man than those who have sold out their professional ideals for a corporation retainer. There is a crude justice in the manner in which the lawyer suspected of the corporation taint is rebuked whenever his name appears on the popular ballot. The people can forgive the capitalist who plays his game for all there is in it, but it cannot forgive his hirelings.

The accountant's fees come from the banker and the corporation official. But it is his particular duty to protect the rights of the private in the industrial army—the small stockholder or the rate payer of the future. It is not enough for him to be timidly neutral in the conflict of interest between the captain of industry and the private. He cannot afford to be too proud to fight for his principles. Sound accounting principles are like the principles of international law. They are designed to protect the rights of the weaker against infringement by the stronger. And they are just as much worth fighting for.

If the accountant is to avoid the fate of the corporation lawyer he must publish his principles and stand for them in the open. He should follow the lead of the modern physician and undertake preventive propaganda. The prevention of bad accounting and unsound administrative practices is like a problem in municipal sanitation. The accountant should be out in front creating a public opinion which will stamp out and make impossible these dangers to the public financial health. It is by such service as this that the accountant can attain the position of trust and honor which distinguishes a professional man from an employee. It is by such service that he will prove his worthiness to aid in the country's industrial preparedness for peace as well as for war.

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EDITORIAL

Government Contracts

The government at Washington has recently entered into a number of important contracts with manufacturing establishments for the production of a wide variety of goods upon the basis of cost of manufacture plus a percentage thereon for profit. It is proposed to adopt this form of contractual arrangement generally for the purchase of the vast quantities of munitions, supplies and equipment required for war purposes. In theory at least the plan is a sound one. It is fair and equitable in that it protects the government from extortionate prices while it ensures a profit to the manufacturer. From its principles there can be no dissent.

In the adoption of the "cost plus" basis it must be remembered that the percentage of profit to be allowed must vary greatly in different industries. What would be only a fair return in an industry in which the capital was turned over slowly, might easily become an exorbitant profit in an industry in which the turnover was rapid. Therefore it will be necessary for the government to exercise peculiar care in contracting to see that the percentage of profit to be allowed in each individual case shall be a percentage yielding only a reasonable return to the manufacturer or other producer.

To the layman cost of manufacture sounds like a quite definite thing. Lawyers, except that relatively small number whose large practice in business affairs has taught them something of the intricacies of industry, believe themselves competent to draw a contract in which cost is defined. Even business men, while using the term with glibness, seldom agree with one another as to the meaning of cost in a particular instance and are often in serious error. Scarcely any other subject in a business contract is so often the subject of dispute.

Why should a thing apparently so simple be in reality so hedged about with difficulties? The first answer must be that nothing worth defining can be defined. At best we can only approximate. If a factory was built and operated for the production of a single uniform product and for a definite period of time at the end of which the plant was dismantled or otherwise wholly disposed of, it would be possible to ascertain closely the total expenditure upon the whole matter. And this sum divided by the total number of units produced would give the cost per unit. Even so the cost would not be known until the end of the period and it would be only the average cost at that. This illustration is, however, not typical of modern industry. We have to deal with what are known as going concerns which make usually many kinds or styles of product, and it is necessary to ascertain the costs of production of each thing or kind of thing produced—and this must be done currently and must reflect the constantly changing conditions of the particular industry. Moreover, a large portion of the sum making up the cost of an article must be ascertained by methods of apportionment of what are technically known as indirect expenditures. For instance, a machine may last twenty years, but its cost must be spread over the product of those years and the cost of its repairs must also be included in the cost of production. A costly machine may be used in producing only a certain type of article; justice requires that other types be not burdened by it.

Cost of production is, then, not the simple, almost elementary thing it appears to the uninitiated. Those who are acquainted with the literature upon the subject know that there is a wide divergence of views therein, not only as to the methods of apportionment to be used, but also as to items that may be included. All, however, agree that few if any hard and fast rules can be laid down as applicable to all industries.

In drawing contracts providing for compensation based upon cost of production, care and intelligence is required in framing the sections relating to these accounting matters. Lawyers who have had any considerable experience in such matters welcome the co-operation of the accountant and every governmental department should secure the counsel of experienced accountants before entering into a cost plus profit contract. This course has been followed by Great Britain since early in the war and must be adopted by Washington if these contracts are to mean what they purport to mean and the amateurish provisions in some of the recent contracts which may prove costly to the government are not to be perpetuated. Business men as a whole are prepared to deal with the government in a patriotic spirit and the attitude of public officials should be a reciprocal one. That it has not been entirely so in the past is regrettable. The present grim business cannot be conducted as it should be without a full recognition by the governmental officials of their own limitations, and perhaps nowhere are those limitations more painfully manifest than in their efforts to draft cost plus profit contracts.

The Federal Reserve Board and Audits

The Federal Reserve Board has recently given its tentative endorsement to a memorandum prepared by a committee of the American Institute of Accountants relative to balance-sheet audits and the work of the auditor in connection therewith. In passing, it is perhaps unfortunate that the title *Uniform Accounting* given to the memorandum by the reserve board is not quite descriptive. This, however, is of minor importance. The memorandum is the outgrowth of the work of the Federal Trade Commission and of its late chairman, Edward N. Hurley, in particular, who during his entire term of office labored zealously and intelligently for the betterment of business and credit conditions.

The memorandum is of such importance that it has been reprinted in full in this issue of THE JOURNAL OF ACCOUNTANCY and we are confident that it will appeal to all our readers. To the members of the institute it will serve as a guide in all their audits for credit purposes, and they will understand that the burden of proof will be upon them if they omit any of the procedure laid down in the memorandum. It must be admitted that some accountants, as there are some men in other professions, are incompetent and sometimes competent men grow careless. The immediate effect of the memorandum will be to check carelessness and the incompetent will have a realizing sense of the risk they run in signing a financial statement which they have not properly audited. The ultimate and more important effect must be to raise immensely the standards of most if not all the audit work now done for credit purposes. The memorandum makes it abundantly clear that a balance-sheet audit goes to the vitals of a business and that it requires professional ability (and sometimes courage) of a high order.

For perhaps the first time the bankers and business men of this country are afforded an opportunity to know just what is meant when they hear or speak of an audit. While in a general way they have of course known that the purpose of an audit was to prove the correctness of a financial statement, many at least have had a rather hazy notion of how it was done and what an audit really covered. Especially have both bankers and business men been slow to understand the significance and importance of qualifications in audit certificates. Now they may learn in a concise and authoritative fashion exactly what an audit is, and it may be predicted confidently that the majority will be agreeably surprised at the scope of an audit and the far-reaching importance of its provisions as outlined in the memorandum.

An important function of the memorandum will be that of indicating to business men precisely how their financial statements must be prepared for presentation to their bankers and to others for credit use. No longer can a man plead ignorance of how to make up a statement or what is meant by a current asset, for instance. The memorandum is far too specific to leave room for doubt as to these matters, and whether financial statements are audited or not it surely must be that greater care and more intelligence will be used in their preparation. To the banker and the credit man the memorandum will be an instrument well fitted to his hand. By means of it he finds a standard by which to measure every statement submitted to him and can cross-examine in a searching manner every borrower who comes before him.

It has been suggested in some quarters that it is unwise to give to the public such a detailed outline of audit procedure, that it will place too much information in the hands of the unscrupulous, that the incompetent will be able to cover up his incompetence and that after all individual judgment and skill are required in making an audit and that no memorandum can take its place. Some of these objections are not without force, but no forward step can be taken that is entirely free from objection and the action of the American Institute of Accountants in preparing and the Federal Trade Commission and the Federal Reserve Board in approving for discussion this memorandum must be judged from the standpoint of its broader and ultimate effects.

Looked at in this light and for the reasons we have attempted to indicate we believe the institute has performed an act of high public duty and that the reserve board has issued a document that will take rank as one of the most far-sighted and important business papers of our time.

Students' Department

EDITED BY SEYMOUR WALTON, C.P.A.

UNISSUED STOCK AND TREASURY STOCK

In the April issue of THE JOURNAL OF ACCOUNTANCY appeared an article on *Treatment of Unissued Stock and Bonds* by Willard H. Lawton, C.P.A., and another on *Treasury Stock and its Relation to Other Balance-Sheet Factors* by George C. Scott, C.P.A. As I have received several letters in regard to these two articles, I may be forgiven for discussing them, although in so doing I may repeat some remarks that have already appeared in this department.

Mr. Lawton says that unissued stock should not be put on the ledger nor appear in the balance-sheet. He bases his objection to it on the ground that if it is put on the books the capital stock account will represent the total authorized stock, whereas the truth is that the actual capital of a corporation is only so much as has been actually paid in in cash or other assets. Mr. Montgomery agrees with him to the extent of saying: "Unissued capital stock is to be distinguished from treasury stock, and good accounting practice does not require any entry therefor in the books of account until it has been subscribed for."

There is no doubt that the actual capital stock is the amount of paid up and issued stock, that stock not fully paid is subscribed stock and that stock that is not even subscribed for is unsubscribed stock, which is a better and more accurate term than unissued stock. The question is not as to the status of these three classes of stock, but as to how they should be treated in the accounts.

Mr. Lawton's reasoning by analogy from total bonds permissible by law to total stock authorized by the charter of any particular corporation is altogether wrong. He clouds the issue by using the expression "bonds authorized by state law," when he should have said "bonds permitted by state law." The law would permit the corporation to issue a certain amount of bonds. Neither the law nor anything else has yet authorized the issue up to the legal limit. If an issue of bonds is authorized by the proper legal steps being taken, Mr. Lawton's journal entry charging bonds authorized would be entirely correct, whether all the bonds had been sold and issued or not, although most persons would prefer to charge treasury bonds. This flaw in the reasoning would have been apparent if Mr. Lawton had confined himself to capital stock and had said that since the law permitted a corporation to fix its authorized capital at any amount, provided that it did not issue more than the conditions justified, the opening entry should be any tremendously large amount, although the charter actually authorized a very much smaller amount.

The principal reason for the contention that unissued stock should be shown on the ledger and also on the balance-sheet is because stockholders are entitled to all the information that it is possible to give them in regard to all the conditions affecting their holdings. While it is true that every stockholder has the right to inspect the books of the corporation, it is certain that very few ever do, and that still fewer would think it necessary to investigate the conditions under which the corporation started or to ask for a copy of the charter to ascertain the authorized capital. The officers and directors are supposed to give the stockholders all the necessary information in regard to the corporation, and to furnish a balance-sheet setting forth that information.

To show how Mr. Lawton's plan might work to the prejudice of stockholders who were ignorant of the existence of a large block of unissued stock, let us suppose that a man owns $20,000 of stock in each of two corporations. In one of them the total authorized stock of $100,000 has been issued, while in the other $100,000 of a total authorized stock of $200,000 is all that has been issued. Mr. Lawton would make no distinction between the capital stock item in the balance-sheets of these two corporations. The difference between them may be very important to the stockholder in question. In the first one the directors cannot raise the capital to $200,000 without submitting the question of the increase to a vote of the stockholders. If the proposition carries, every stockholder has notice of it and also has a right to subscribe and pay for his proper proportion of the new stock. In a very prosperous company this right may be valuable, even if the new stock is sold at book value.

In the case of the second corporation the directors could at any time sell the unissued stock without notice to the stockholders and without their having any right to take any part of it. The man who thought that he was the owner of one-fifth of the stock now finds that he owns only one-tenth of it, and he has no way to protect himself, unless he can show that the directors have sold the stock much below its book value. Unless the doubling of the capital will result in doubling the net profits, he has suffered a positive loss.

Mr. Lawton seems to think that it is absolutely wrong to extend into the main column of a balance-sheet an amount which does not represent the balance of some account on the ledger. The capital stock on the balance-sheet is the amount appearing in that account; from it is deducted the unissued stock, which is the balance of that account; the difference is carried out as stock issued and outstanding, and is the balance of no account. This looks like a good argument, but it is so only if the definition of a balance-sheet is modified so that no deduction of one account from another is permitted. In that case those accountants who deduct the reserve for depreciation from the asset on the balance-sheet must revise their methods and must set up all reserves as liabilities. Otherwise their balance-sheet will offend against Mr. Lawton's self-imposed law as follows:

Machinery (balance on ledger)	50,000	
Less reserve (balance on ledger)	10,000	
Net carried out (not on ledger)		40,000

Is it possible that many good authorities have thus been guilty of false accounting?

To set up the total authorized capital stock on the credit side of the balance-sheet and to carry unissued stock as an asset on the other side might lead a careless investigator to infer that the whole capital had been paid for and issued. What kind of an investigator would be so careless it is difficult to imagine. An existing or a prospective creditor would inquire as to the relation between the valid assets and the outside liabilities. If he saw a large capital stock credit, he would certainly notice whether there was also a large goodwill asset or possibly a discount on stock debit. If there was a large debit to unissued stock also, he would hardly overlook it. An investigating stockholder would hardly stop his inquiry into the condition of his corporation when he had noted the capital stock item. He would certainly wish to know how the capital had been invested and what was the present condition as to assets.

A careless person might be equally deceived as to the value of a plant, if the balance-sheet showed a very large item of plant at original cost on the debit side and a reserve for depreciation on the credit side amounting to 33-1/3 per cent. of the plant value. If he considered only the asset values without looking for offsetting credits or for liabilities, he might get an extremely erroneous view of the condition of the corporation. The deduction of the reserve from the assets on the balance-sheet is made so as to furnish the investigator with the whole information in the most convenient form, and the same is true in regard to the deduction of unissued or unsubscribed stock from capital stock.

Whatever may be said about the propriety of leaving unissued stock entirely out of the balance-sheet, it does not seem possible to justify the exclusion of unissued bonds. While it is true that a bond does not become an active debt until it is sold to an outside holder, it is a potential debt as soon as it is certified by the trustee, and represents an actual lien against the property which is mortgaged to secure it. If the object of a balance-sheet is to give information in regard to the condition of a corporation, it is certainly necessary to exhibit the full extent to which the property is mortgaged, whether the directors have or have not seen fit to take full advantage of the mortgage up to the present. This information can be furnished only by putting the entire authorized issue on the books and on the balance-sheet. Then the further information is given that the entire issue has not been sold, if such is the case, by leaving the unsold bonds in the account of treasury bonds, where they are a notice to both creditors and stockholders that the company has an anchor to windward in the shape of bonds that can be sold or that can be used as collateral whenever money is needed permanently or temporarily in the business.

As to bonds used as collateral, Mr. Lawton says "the facts should, of course, be shown in the ledger in proper contingent assets and contingent liability accounts: and on the balance-sheet the balances of these accounts should appear as 'per contra' items or may be assembled on the liability side 'in short' if preferred." There is no doubt that a professional auditor should note on his balance-sheet the fact that unsold bonds have been used as collateral for notes payable, by splitting his treasury bonds into those on hand and those out as collateral; but it is doubtful whether the bookkeeper of a corporation could be severely criticized for ignoring entirely the fact that the bonds had been hypothecated. In that case there would be no record of the unsold bonds, even if they were in the hands of creditors.

With regard to treasury stock, Mr. Scott quotes several authorities who say that it should be considered an asset, since it represents something for which actual value has been paid and is property which can be sold. He objects to the classification, because treasury stock cannot be considered as part of the net worth of the corporation, that is, of its net assets. It is extremely difficult sometimes to draw the line between those things which are assets and those which are deductions from liabilities. In the case of treasury stock it seems to be sufficient to say that in the trial balance it is carried as a debit or quasi-asset, and in the balance-sheet as a deduction from the capital stock, as Mr. Scott himself treats it. Instead of showing capital stock, less treasury stock, and carrying out the net stock outstanding, he adds together capital stock, surplus and reserve for extinguishment of bonds, and deducts treasury stock from the total, which shows neither the net outstanding stock nor the total surplus. It would be better for his balance-sheet to show under the sub-head "net worth"

Capital stock	50,000		
Less in treasury	15,000	35,000	
Free surplus	39,000		
Surplus appropriated for bonds purchased	5,000	44,000	79,000

Why bonds purchased for retirement are not retired, canceled and charged off at once instead of being carried as "bonds in treasury for retirement" is not explained. If they are purchased for retirement it can hardly be that they are to be considered as sinking fund bonds. The so-called reserve against them should be shown definitely as part of the surplus.

There is one statement made by Mr. Scott that few, if any, will agree with. He says: "The word asset as used in a balance-sheet means a tangible thing or obligation receivable of legitimate value required to conserve the amount of the net value of a business." He argues from this that since treasury stock is not a tangible thing or obligation receivable and that since it rather reduces than conserves the net worth of the business, it cannot be an asset.

There is no warrant for stating that all the assets on a balance-sheet must be tangible in their nature. Goodwill is not a tangible thing, but it may be a very valuable asset to a going concern. Deferred charges to operating are not obligations receivable in money, although they may be covered by the definition because they are receivable in service.

One correspondent referring to this question, says: "In the event that a corporation with $100,000 capital stock shows a net profit from the year's operation of $15,000, and has among its resources $10,000 of treasury stock, has it not a right to declare a dividend of 10 per cent and direct that it be a stock dividend to be paid from the treasury stock? Good authorities sanction such practice. Also the fact that treasury stock may be sold at a discount in time of need appears a fair argument that it is an asset of a higher order than unissued stock, the sale of which at a discount would render the purchaser liable for the discount in nearly all the states. The fact that it appears on the balance-sheet on the assets side does not conceal in any sense the knowledge of its existence from creditors."

Of course there is no doubt that a dividend of 10 per cent. could be declared and could be paid out of the treasury stock. A point that must not be overlooked is that, since the outstanding stock is only $90,000, the dividend would be only $9,000, and there would still remain $1,000 in the treasury. Of course, treasury stock, being temporarily dormant, could not receive any dividend. If it did receive one of $1,000, there would then be $11,000 stock in the treasury, of which the dividend would absorb only $10,000, leaving $1,000 still in the treasury as before.

Grain and Flour Futures

Editor, The Journal of Accountancy:

Sir: As chief of the accounting department in a large mill, I often wonder why it is that there is such a lack of standardization in some of the phases of mill accounting. For instance, I have not found any two men in the accounting end of the mill business that seem to have the same opinion about the method of closing out (or inventorying) the outstanding options and the booked flour.

I am handing you herewith a copy of what I call a "statement of futures" which I have spent a good deal of time with, during the last two years, and which I believe fills the bill better than any system of averages that could be applied. I wish you would give this statement some space in your Journal, and either discuss it yourself or invite others to do so.

It is understood, of course, that in the milling business, wheat options are bought and sold as well as the cash wheat, and that this is done in some cases regardless of whether or not a quantity of flour sales has been booked for future delivery to warrant the transactions in wheat options.

Yours truly,

Benson, Nebraska. W. H. Justin.

(Statement of Futures)

It is understood that the result of this statement is to be carried to the proper place (either as an asset or as a liability) in the regular balance-sheet, which is compiled from the trial balance and the inventories at the close of the fiscal period. In other words, the result of this statement is to be regarded as an inventory of "futures."

1. Grain options long:
   - (a) Options bought—at actual cost..................................
   - (b) Options bought—at prevailing market price on last day of fiscal period ....
   - (c) Difference between (a) and (b), unrealized loss or gain on grain options long ....
2. Grain options short:
   - (a) Options sold—at actual price booked...........................
   - (b) Options sold—at prevailing market price on last day of fiscal period ....
   - (c) Difference between (a) and (b), unrealized loss or gain on grain options short..
3. 1—(c) plus or minus 2—(c), or vice versa, gives net unrealized loss or gain on all grain options outstanding at close of fiscal period ....
4. Flour bookings:
   - (a) Flour bookings—at actual price booked, bulk at mill............
   - (b) Wheat necessary to fill these bookings, as follows:
     - (1) Wheat in elevator, at actual cost.................
     - (2) Wheat in transit, at actual cost...................
     - (3) Wheat bought but not yet shipped at actual cost ....
     - (4) Balance needed (if any), at prevailing market price on last day of fiscal period........
     - (5) Total cost of wheat necessary to fill booked flour, the sum of (1), (2), (3) & (4) above ....
   - (c) Value of by-product manufactured in grinding this wheat........
   - (d) Value of (b)—(5) minus (c), net cost of wheat necessary to fill booked flour orders...................................
   - (e) Difference between (a) and (d), unrealized loss or gain on booked flour ....
5. Difference between (or sum of, as the case might be) 3 and 4—(e), net unrealized loss or gain on all outstanding futures, at close of fiscal period...............................

This is a subject that has never received proper attention from accountants. In an ordinary manufacturing or trading business the principle has been adopted of inventorying at cost or market, whichever is lower, the latter price being that at which the goods could be purchased. In the grain trade and those allied with it and in the stock and bond business the prevalent practice is to inventory at the market price, whether that is higher or lower than cost, thus putting on the books an unrealized profit or loss as if it were an accomplished result.

Our correspondent avoids this by calling the result an unrealized profit or loss. Such a statement as he makes would be interesting as showing the wisdom of the purchases and sales made, but it does not seem necessary to put this information on the books as long as it is avowedly unrealized, and it certainly does not seem correct to put it on the books and to carry the result to profit and loss as a fact.

It would be interesting to know to what extent accountants agree with millers and grain dealers in regard to the general practice of inventorying at the market price.

Preferred Dividends

Editor, Students' Department:

SIR: The question arises how to treat dividends on treasury stock. It appears to me that setting up on the books dividends of this kind is of little use as, according to my theory, the amount would only return to the credit of profit and loss again. Then why not ignore dividends of this character? It can in no sense be classed as an earning of the corporation, can it?

A large corporation which has an issue of 7% cumulative preferred showed a net profit for the fiscal year ended December 30, 1916, of $50,000. The dividends on the preferred for 1916 would be $7,000. (All dividends on preferred had been paid up to December 31, 1915, during 1916.) The accountant who prepared the balance-sheet as of December 30, 1916, set up on the books as a liability the $7,000, although the board of directors had not declared this as a dividend. The accountant's action, in doing this, is contradictory to accounting authorities, who maintain that dividends are not a liability until they have been declared by the board of directors.

It appears to me that inasmuch as the stock carries 7%, provided the net profit amounts to that, this amount at the close of the fiscal period at once becomes a liability payable at the discretion of the board of directors.

I assure you I would appreciate your help out of these difficulties.

Very truly yours,

Rochester, New York. RAYMOND V. ELLIS.

No dividend is ever paid on treasury stock, because it would be exactly offset by a credit of the amount of the dividend.

Even when stock is cumulative preferred and there is surplus on hand out of which to pay the current dividend, it is not correct to set up a liability for the dividend until the board of directors shall have declared it by formal action. The accountant would be authorized to show in the balance-sheet a note after the word surplus "subject to preferred dividend $7,000," but he has no right to set it up as an actual liability.

As long as the board of directors can reasonably claim that the proceeds of any profits made are needed in the business as working capital, they are not obliged to declare any dividends, even those of a cumulative preferred character. The only restriction on the directors is that they cannot declare or pay any dividends on the common stock until all accumulated dividends on the preferred have been paid.

The object of making the note on the balance-sheet in regard to the deferred preferred dividend is to give notice to the preferred stockholders of the amount they would eventually receive, and to the common stockholders that all the surplus did not belong to them.

Inventory on the Books

Editor, Students' Department:

SIR: Where a going inventory is not maintained and for purposes of a monthly profit and loss an estimated cost of sales based on previous experience is used, is it not necessary to pass a journal entry each month debiting an account "cost of sales" and crediting "materials purchased" or "inventory"?

Also, what is the theory involved in the practice of leaving an inventory account intact during a year's operations, charging all purchases to a "materials purchased" account? STUDENT.

If a concern closes its books monthly and does not take an actual inventory or maintain a going or running inventory, it would have to use an estimated inventory, but this would be used exactly in the same way that an actual inventory would be used. The result, of course, would only be as accurate as the estimate of the inventory is, and could not be relied on for any purpose.

I do not know that any theory is involved in carrying the inventory account intact through the year. The excuse for it is that the purchase account now shows the exact amount bought during the year. I have never seen any advantage in obtaining this information. What the business man wants to know is how much material he consumed, if a manufacturer, or what the cost of the goods sold amounted to, if a trader. When he purchased the material or the goods is entirely immaterial. The purchases in a year are no guide at all to the determination of how much it will be necessary to purchase in another year, but the amount consumed or sold is a guide. The difference may be easily illustrated.

Suppose a concern starts the year with an inventory of raw material of $10,000, purchases $160,000 during the year and has an inventory of $50,000 at the end. The amount consumed would be $120,000. The next year it purchases $80,000 and has an inventory at the end of $10,000. The consumption is again $120,000. The important point is that the consumption is the same for the two years, $10,000 average per month. This information notifies the manager that at the end of the first year he has a supply on hand sufficient for five months' demand, and at the end of the second year of only one month's. There is no good purpose served in carrying the beginning inventory clear through the year or in keeping a separate account with the purchases of the year. The inventory should be brought down as a balance of the purchases account as unused purchases on hand.

It would then be lost sight of on the books, exactly as the material which it represents is lost sight of in the factory by being mixed with subsequent purchases.

The following problem was given in the C.P.A. examination in Illinois in December, 1916.

PROBLEM

On January 1, 1916, the Never Slip Razor Company was incorporated with a capital stock of $50,000.00, subscribed as follows:

J. Colgate	$10,000.00
T. Williams	20,000.00
R. Armour	20,000.00

Colgate's subscription was settled by the transfer of patent rights to the company. Williams and Armour paid cash.

W. Morgan was appointed manager, at a salary of $5,000.00, and 10% commission on the profits prior to charging his commission.

As at December 31, 1915, the financial position of the company was as follows:

Assets:	
Current and working	$75,000.00
Patents, etc.	65,000.00
Total	$140,000.00

Liabilities	
Current and accrued	$10,000.00
Capital stock	50,000.00
Surplus	80,000.00
Total	$140,000.00

The current and accrued liabilities of $10,000.00 include $4,000.00 due to W. Morgan for excess of salary and commission to date over drawings.

The profit and loss account for the ten years showed net profits available for dividends as follows:

1906	$4,500.00
1907	13,500.00
1908	27,000.00
1909	18,000.00
1910	27,000.00
1911	36,000.00
1912	45,000.00
1913	63,000.00
1914	81,000.00
1915	126,000.00
Total	$441,000.00

It was decided to form a new company, the Never Slip Corporation, with a capital stock of $500,000.00, to take over the business as at January 1, 1916.

Stock was to be allotted to the original stockholders of the old company in the ratio of eight new shares for one old share. The balance was to be issued to W. Morgan to secure his services as manager, with an annual salary of $5,000.00 and no commission.

The patents account in the books of the old company was as follows:

Jan. 1, 1906, Patent rights acquired from J. Colgate	$10,000.00
Dec. 31, 1906 Application fees, attorney fees, etc.	1,000.00
Dec. 31, 1907 Application fees, attorney fees, etc.	500.00
Dec. 31, 1908 Application fees, attorney fees, etc.	500.00
Dec. 31, 1909 Application fees, attorney fees, etc.	2,000.00
Dec. 31, 1910 Application fees, attorney fees, etc.	12,000.00
Dec. 31, 1911 Application fees, attorney fees, etc.	8,000.00
Dec. 31, 1912 Application fees, attorney fees, etc.	7,000.00
Dec. 31, 1913 Application fees, attorney fees, etc.	7,000.00
Dec. 31, 1914 Application fees, attorney fees, etc.	7,000.00
Dec. 31, 1915 Application fees, attorney fees, etc.	10,000.00
Total	$65,000.00

The date of the principal patent was January 1, 1909. It was decided that all expenditure on patents until that date should be capitalized. But, after that date, the account was to be adjusted by providing for writing off the principal patent by January 1, 1926; all expenditure before and after January 1, 1909, being considered as connected with the principal patent.

Show how you would adjust the patents account. Also adjust the accounts so that W. Morgan is credited with 20% commission in lieu of salary and 10% during the 5 years ended December 31, 1915. Give (1) W. Morgan's account, (2) a summary of net profits for the 10 years, (3) balance-sheet of the old company, (4) balance-sheet of the new company, (5) and a recommendation as to depreciation to be written off the intangible assets of the new company.

SOLUTION

EXHIBIT A

NEVER SLIP RAZOR COMPANY

STATEMENT OF THE PATENT ACCOUNT AS ADJUSTED

Date	Annual Proportion Written Off Fraction	Amount	Balance After Writing Off Proportion	Application Fees, Attorney's Fees, Etc.	Balance After Writing off Annual Proportion and Adding Fees
Jan. 1, 1906				10,000.00	10,000.00
Dec. 31, 1906				1,000.00	11,000.00
" " 1907				500.00	11,500.00
" " 1908				500.00	12,000.00
" " 1909	1/17	705.88	11,294.12	2,000.00	13,294.12
" " 1910	1/16	830.88	12,463.24	12,000.00	24,463.24
" " 1911	1/15	1,630.88	22,832.36	8,000.00	30,832.36
" " 1912	1/14	2,202.31	28,630.05	7,000.00	35,630.05
" " 1913	1/13	2,740.77	32,889.28	7,000.00	39,889.28
" " 1914	1/12	3,324.11	36,565.17	7,000.00	43,565.17
" " 1915	1/11	3,960.47	39,604.70	10,000.00	49,604.70
		15,395.30		65,000.00	

Total expenditures to date	65,000.00
Proportions written off	15,395.30
Balance Dec. 31, 1915	49,604.70

EXHIBIT B1

NEVER SLIP RAZOR COMPANY

SUMMARY OF NET PROFITS FROM JANUARY 1, 1906 TO DECEMBER 31, 1915

Year	Balance as Shown	W. Morgan's 10% Commission	Net Profits Basis of Commission	W. Morgan's Salary	Total Before Charging Salary
1906	4,500.00	500.00	5,000.00	5,000.00	10,000.00
1907	13,500.00	1,500.00	15,000.00	5,000.00	20,000.00
1908	27,000.00	3,000.00	30,000.00	5,000.00	35,000.00
1909	18,000.00	2,000.00	20,000.00	5,000.00	25,000.00
1910	27,000.00	3,000.00	30,000.00	5,000.00	35,000.00
1911	36,000.00	4,000.00	40,000.00	5,000.00	45,000.00
1912	45,000.00	5,000.00	50,000.00	5,000.00	55,000.00
1913	63,000.00	7,000.00	70,000.00	5,000.00	75,000.00
1914	81,000.00	9,000.00	90,000.00	5,000.00	95,000.00
1915	126,000.00	14,000.00	140,000.00	5,000.00	145,000.00
Totals	441,000.00	49,000.00	490.000.00	50,000.00	540,000.00

The above statement is necessary in order to obtain the figures to be added back to ascertain the net profits as the adjusted basis on which Morgan's 20 per cent. of commission is to be calculated. It is to be noted that this commission is now affected by the charging off of annual amounts in reduction of the patent.

As the problem states that the net profits given in the table are those available for dividends, it is plain that Morgan's commission has already been deducted.

EXHIBIT B2

NEVER SLIP RAZOR COMPANY
ADJUSTMENTS OF NET PROFIT

Year	Net Profit as Shown	Add Back Morgan's Salary & Com.	Deduct Patent Reduction	Basis of Morgan's Commission	Deduct Morgan's 20% Com.	Adjusted Net Profit
1906	4,500.00					4,500.00
1907	13,500.00					13,500.00
1908	27,000.00					27,000.00
1909	18,000.00		705.88			17,294.12
1910	27,000.00		830.88			26,169.12
1911	36,000.00	9,000.00	1,630.88	43,369.12	8,673.82	34,695.30
1912	45,000.00	10,000.00	2,202.31	52,797.69	10,559.54	42,238.15
1913	63,000.00	12,000.00	2,740.77	72,259.23	14,451.85	57,807.38
1914	81,000.00	14,000.00	3,324.11	91,675.89	18,335.18	73,340.71
1915	126,000.00	19,000.00	3,960.47	141,039.53	28,207.91	112,831.62
Totals	441,000.00	64,000.00	15,395.30	401,141.46	80,228.30	409,376.40

EXHIBIT B3

	SUMMARY Net Profit	Surplus
Total per books	441,000.00	80,000.00
Add back Morgan's $5,000 & 10%	64,000.00	64,000.00
	505,000.00	144,000.00
Deduct: Patent reduction	15,395.30	15,395.30
Morgan's 20% com.	80,228.30	80,228.30
Net, as adjusted	409,376.40	48,376.40

EXHIBIT C.

Summary of W. Morgan's Account
January 1, 1906—December 31, 1915

Credits for salary (exhibit B-1)	50,000.00
Credits for commission (exhibit B-1)	49,000.00
Total credits per books	99,000.00
Deduct drawings	95,000.00
Balance per books	4,000.00
Credits for commission at 20% 1911-1915 (exhibit B-2)	80,228.30
Total	84,228.30
Deduct commission at 10% & salary 1911-1915 (exhibit B-2)	64,000.00
Balance Dec. 31, 1915, as adjusted	20,228.30

EXHIBIT D.

The Never Slip Razor Company
Balance Sheet
December 31, 1915

Assets		Liabilities	
Current and working assets	75,000.00	W. Morgan (exhibit C)	20,228.30
Patents (exhibit A)	49,604.70	Current and working liabilities	6,000.00
		Capital stock	50,000.00
		Surplus (exhibit B3)	48,376.40
	124,604.70		124,604.70

EXHIBIT E.

The Never Slip Corporation
Balance Sheet
January 1, 1916

Assets		Liabilities	
Current and working assets	75,000.00	W. Morgan	20,228.30
Patents	49,604.70	Current and working liabilities	6,000.00
Goodwill	401,623.60	Capital stock	500,000.00
	526,228.30		526,228.30

The old capital stock being $50,000, the gift of eight shares for one would take up $400,000 of the new stock. The remaining $100,000 would be given to W. Morgan. The increase of $450,000 would have to be charged to goodwill, although it might be divided into goodwill of the business

$350,000 and goodwill of W. Morgan $100,000. The old surplus of $48,-376.40 would, of course, be deducted from the goodwill, leaving the net amount, which is the difference between the net assets of the old company and the stock of the new company which was paid for them.

In regard to the intangible assets, the patent, if that is classed as intangible, should be written down pro-rata with the number of years it has to run. While it is not imperative that the goodwill should be written off, it is better to reduce it at least to a reasonable amount. A complication arises, however, from the fact that if $400,000, or any sum near it, is charged against future profits, it will mean that the quick assets representing this sum will be increased to the same extent. Unless the future business of the company requires this large addition to its working capital or unless a large part of it can be changed into fixed assets, there will be a large accumulation of cash, which cannot be distributed as dividends, owing to the reduction of surplus by charging off the goodwill which the company does not need. The only way this cash could be distributed among the stockholders would be by a reduction of the capital stock.

Equalizing Sales

Editor, Students' Department:

Sir: I would be pleased to have you advise me on the following:—We sell goods (boilers and tanks) both to dealers and to the consumer direct, and we sell much greater quantity to dealers than we do to consumers direct. I have been charging the dealer with dealer's price (as we have a fixed dealer's price on each article based on about a 10 per cent. commission) and crediting sales account with the same amount. In this way you will see that our sales account at the end of the year is lower than it would have been had we sold all our output to consumers. For example, I have been making my entries as follows:

Producers Oil Co.	325.00	
Boiler sales		325.00

This is a sale to a dealer. If sold to a consumer the goods would have been billed at $360.00.

I really believe that I should make my entries in the following way, regardless of how much we sell to the dealers, as it seems more definite. Advise which way is correct.

Producers Oil Company	325.00	
Commission	35.00	
Boiler sales		360.00

Yours respectfully,
R. W. K.

I do not see that you would be justified in swelling the amount of your sales on one side and offsetting the increase by a charge to commissions on the other. You do not actually pay or allow any commissions, as I understand it.

A very much better way would be to keep two sales accounts—sales to dealers and sales to consumers. The detail of how you would keep the two separate depends upon the way you record your sales. Probably it would be a matter of providing an extra column. It can be done by having a recapitulation sheet or book with two columns.

This will give you full information in regard to the division of your sales between the two classes and will avoid the opening of a fictitious account with commissions.

The amount of $35.00, which you call commission, is really a trade discount, and as such would not appear in the accounts. By lumping all the sales into one account, as you propose, there would be no way to determine how much the sales to dealers amounted to, and therefore no way to show what effect the allowance of the discount would have on the sales to dealers in regard to the profit actually made. Even under your method the two classes of sales should be kept separate.

Certified Public Accountants of Massachusetts, Inc.

The Certified Public Accountants of Massachusetts, Inc., held their annual banquet in Boston, April 18th. Addresses were given by the bank commissioner and the toastmaster, F. R. Carnegie Steele. The dinner was followed by music and dancing.

At the annual meeting of the Certified Public Accountants of Massachusetts, Inc., on May 9th, it was reported that the membership consisted of about one hundred accountants. The officers and committee for the ensuing year were elected as follows: F. R. Carnegie Steele, president; Edwin L. Pride, vice-president; George Lyall, secretary; Gerald Wyman, treasurer; the officers and J. E. Masters, Waldron H. Rand and Hollis H. Sawyer, executive committee.

It was voted to contribute $250 to the American Red Cross fund and $250 to the endowment fund of the American Institute of Accountants, subject to confirmation at the next meeting.

In response to an invitation from the income tax deputy for Massachusetts, the executive committee was authorized to forward recommendations regarding the state income tax blanks for 1918.

Income Tax Department

EDITED BY JOHN B. NIVEN, C.P.A.

It had been expected that the provisions of the law in regard to the war taxes would be available for publication in the current issue of THE JOURNAL OF ACCOUNTANCY. At the time of writing, however, the revenue bill is still being discussed in congress and it is impossible to say what the exact terms of the statutory enactment will be. All reference to the new taxes is therefore postponed until next month.

The treasury department has issued a ruling, as T. D. 2481, defining the present position of charges for depreciation allowable as deductions in ascertaining the net taxable income of corporations, joint stock companies, etc., under the income tax law.

The income tax law of 1913 authorized corporations, joint stock companies, etc., in making their returns of annual net income to deduct from gross income "all losses actually sustained within the year, . . . including a reasonable allowance for depreciation by use, wear and tear of property, if any." In the law of September 8, 1916, the similar provision had the words "and charged off" inserted between the word "sustained" and the word "within" and the depreciation deductible was more particularly described. The exact terms were: "all losses actually sustained and charged off within the year, . . . including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade."

It will be remembered that the department in effect wrote into the statute of 1913 the words "and charged off" and insisted that the charge for depreciation to be allowable as a deduction for income tax purposes had to be so entered on the books as to constitute a liability against the assets of the company and be reflected in the annual balance-sheet of the company. In the ruling now published the department has departed from its former position and now states that as to returns made under the corporation excise tax law of 1909 and the income tax law of 1913 the writing off of depreciation, if reasonable in amount, will not be insisted upon. It is satisfactory to know that the department has at last reached this reasonable state of mind on the point; but there is little consolation to the corporation official who had prepared his return on this basis originally and was forced to relinquish the charge on account of the opinion on the point which prevailed in Washington at the time his return was filed.

In the 1916 law the provision is specific in its terms and the department is enforcing the requirement that the amounts deductible on account of depreciation and depletion should be charged off and should be reasonable allowances.

The department, in the same ruling, also states its present position on a point with regard to which conflicting rulings have been given from time to time. It is now stated that there is no requirement of law that the funds, represented by the reserves created to offset the reasonable allowances deducted from gross income on account of depreciation or depletion should be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed or in restoring the capital invested in the depleted assets, and that such funds may be converted into tangible assets or invested in the way most suitable for the interests of the business.

Correspondence

Question: Has there been a decision by the supreme court to the effect that a corporation may deduct a fair amount of depreciation, even though not actually accrued on the books of account?

Has a corporation accruing a renewal and replacement reserve (which is based on a fixed percentage of gross operating revenue and which reserve is in fact an excess maintenance reserve) a right to make a still further deduction to care for depreciation even though not actually accrued on the books of account?

Answer: The ruling given this month seems to cover the question raised by the correspondent. The income tax law permits a corporation to deduct a charge for depreciation only when the amount is "charged off" on the books of account and it is a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation. It does not seem material how the amount of depreciation is arrived at provided, in fact, it represents a reasonable allowance; though the department in a previous ruling, stated that the rule it had established, and which was very generally followed by corporations, contemplated that an allowable depreciation deduction within the meaning of the federal income tax law should be computed upon the basis of the cost of the property and the probable number of years constituting its life. The life of property necessarily depends upon its character, the uses to which it is put, and the conditions under which it is used. These elements being taken into consideration, corporations should, as a result of experience and observation, very closely approximate the number of years constituting the life of the property and upon this basis determine the rate of depreciation which annually occurs.

The depreciation charge on the basis above indicated is the only deduction of that nature allowed under the federal income tax law.

TREASURY DECISIONS ON INCOME TAX

(T. D. 2481, April 10, 1917.)

Reserves for depreciation and depletion constitute proper deductions from gross income, if reasonable, and not to be disallowed if converted into other forms of assets.

The "second" paragraph under section 12 of title I. of the act of September 8, 1916, authorizes corporations, joint-stock companies, etc., in making their returns of annual net income, to deduct from gross income "all losses actually sustained and *charged off* within the year, * * * including a reasonable allowance for the exhaustion, wear and tear of property, arising out of its use or employment in the business or trade," and in the case of oil and gas wells and mines a reasonable allowance for depletion of natural deposits.

The essential requirements of this provision are that the amount deductible on account of depreciation and depletion shall be charged off and shall be reasonable allowances; that is, an amount sufficient to make good the loss due to these causes. The phrase "charged off" contemplates that the "reasonable allowance" deducted from gross income on account of depreciation or depletion shall be credited to appropriate reserve accounts and carried as a liability against the assets, to the end that when the total of these credits equals the capital investment account no further deductions on these accounts will be allowed.

While the presumption is that amounts credited to these accounts will be used to make good the loss sustained, either through a renewal or replacement of the property or a return of capital, there is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed or in restoring the capital invested in the depleted assets.

The conversion of the depreciation reserve into tangible assets will not constitute such a diversion as would deny the corporation the right of deduction, provided in all cases that the deduction claimed in the return is a reasonable allowance; that is, a fair measure of the loss due to "exhaustion, wear and tear of property arising out of its use" and is charged off or so entered upon the books as to constitute a liability against the assets with respect to which the depreciation deduction is claimed.

To the extent that articles 130, 132, and 133 of regulations No. 33 are in conflict with the foregoing they are hereby rescinded, and this decision is made applicable to the adjustment of returns of annual net income made pursuant to the requirements of section 38 of the act of August 5, 1909, section 2 of the act of October 3, 1913, and the present income-tax law, except that as to returns made under the first two acts the writing off of depreciation, if reasonable in amount, will not be insisted upon.

Correspondence

Practical Experience Decried

Editor, The Journal of Accountancy:

SIR: The text of the standard C.P.A. law which appears in the January number of THE JOURNAL OF ACCOUNTANCY, by the requirement as to accounting experience—apprenticeship or independent practice—brings to mind an article by John A. Will, C.P.A., condemning such a requirement.

Those who drafted this law doubtless had the best of intentions; but such a law in fact subjects the ambitious young man of today to the system of apprenticeship which had its origin in the English trade guilds of the twelfth century, such system later receiving the sanction of law, but, in the eighteenth century these laws, having become ill adapted to the new conditions were repealed or entirely forgotten.

Under the influence of the trade guilds and the educational system at that time the professions of law, medicine and accountancy developed, but present-day conditions make the apprentice system unnecessary and undesirable in the United States. And were one inclined to question motives, the provision of the law to which reference is made might give rise to speculation as to whether or not its framers had an eye single to the public good.

A wise law governing the practice of accountancy should require a written examination of every candidate for a certificate, unless he has been certified by a state having a satisfactory law, and should require high standards of general and technical education. But to demand that the candidate shall have had at least five years' experience, "two of which shall have been in public practice on his own account or in the office of a public accountant in active practice" encourages or even makes necessary his obtaining a position as bookkeeper at an early age and later securing employment with a practising accounting or, failing in this, opening an office of his own—the "office" seeming to be the important thing, inasmuch as the law is silent as to the number of clients who must suffer in his more or less untrained hands; while, as a matter of fact, this young practitioner and the public would have been immensely the gainer if the accountant had spent a like period of time in a university or school of finance. Let no one delude himself that the profession will truly develop as a result of the provisions of this standard law.

Many certified public accountants seem to liken the practice of accounting and the preparation therefor to that required in the professions of law and medicine, yet no consistent effort is made to place the former on an equal professional plane.

Generally, experience in a lawyer's office is not a requisite for admission to the bar, although in some states it is demanded in lieu of graduation from a recognized law school. Perhaps all states require that persons in order to obtain licence to practice surgery or medicine shall have a diploma from a reputable medical school, "reputable" being defined. In all medical schools of standing, clinics are a part of the curricula, but five years' experience in medicine, two of which shall have been in public practice on his own account or in the office of a physician in active practice is not, fortunately for the practitioner and the public, a requirement.

To insist upon experience before the issuance of a certificate is to approve of a practice that should, for the protection of the public and the best interests of the profession, be condemned unqualifiedly—that is, engaging in public practice without a certificate. It is not to be denied that preliminary experience with a capable accountant would be of great value to the candidate; but where, as is the case in many states, the number of public accountants is very limited (in some states there is not a certified public accountant) preliminary experience, to get away from the word "apprenticeship," is an absurdity and the practice on the candidate's own account an injustice to the public.

It must not be forgotten that nearly all candidates for certificates have had many years of experience with large institutions, which certainly equips the young man for the practice of public accounting as well as does the experience of the lawyer's clerk for the practice of law.

I would have the educational requirements for C.P.A. certificates high —as high as if not higher than they now are—and would find no great criticism if a college training were required by law, although it might be pertinent to ask what percentage of the lawyers of the country and the members of the American Institute of Accountants is college trained. If all the states, or many of them, could boast of institutions where the necessary knowledge of theory and under the direction of whose faculty some practical experience might be gained, then the young man desiring to enter the profession could feel that no injustice is being worked upon him even if graduation from such an institution be a requisite; but very few universities in the United States do maintain such departments and are not likely to establish them for years to come.

Many young men of ambition in the employ of corporations would secure the necessary theoretical training and write on C.P.A. examinations if not arbitrarily ruled out by legal requirements. Only a few of such men would ever enter public practice; and every man on the staff of such a concern to whom a certificate might be issued would become a valuable booster for the profession.

If accountancy is a trade, call it such; if a profession, then act accordingly. It is high time the accountants of standing in this country recognize the facts and get away from trade apprenticeship.

Yours truly,

A Subscriber.

South Dakota Society of Public Accountants

An association of public accountants has been formed in South Dakota under the name of the South Dakota Society of Public Accountants, with the following officers: F. B. Eckert, president, Aberdeen; C. C. Crandall, vice-president, Sioux Falls; M. T. Coogan, secretary-treasurer, Sioux Falls; H. W. Gardner, auditor, Huron; directors: R. R. MacGregor, Yankton; W. A. Shurtleff, Parker, and C. C. Crandall, Sioux Falls.

L. Comingor, William J. Ryans and L. Tipton Young announce the formation of a partnership for the practice of public accounting under the firm name of Comingor, Ryans and Young, with offices at 805 Starks building, Louisville, Kentucky.

Herbert G. Stockwell & Co., announce that their firm name has been changed to Stockwell, Wilson & Linvill, but the partnership interests and organization remain unchanged.

Book Reviews

MANUFACTURING COSTS AND ACCOUNTS, by A. HAMILTON CHURCH, *McGraw-Hill Book Company,* New York, 1917. $5.00 net.

This new volume is designed to introduce students gradually to the underlying principles upon which manufacturing accounting of all kinds must rest. The book is divided into three parts. The first consists of a general outline of manufacturing accounts; the second describes the technique of cost accounting; and the third deals with factory reports and returns. Part 1 discusses the fundamental processes of purchasing, producing and marketing, gives a bird's-eye view of the mechanism of general and cost accounting, outlines three fundamental methods of costing (which will be mentioned below) and discusses waste, spoilage, scrap, by-products and other matters incidental to costing. Part 2 discusses the handling of purchases and stores, and then after a presentation of various systems of orders details the methods of cost accounting under the three fundamental schemes. Part 3 outlines reports for foremen, superintendents and executives.

The book presents many forms, some of which contain illustrative entries, but the general purpose of the author, as stated on page 124, is "to present blanks and forms which are typical rather than specific." The forms for reports are unique, and of suggestive value for one who desires to get away from the conventional forms. It is somewhat to be regretted, however, that the author does not devote more space to graphic methods which he himself considers very desirable in certain cases (see page 111). Some of the accounting forms and reports are subject to the criticism that they do not conform to the usual accounting practice. For example, the reports on page 112 and in part 3 would be improved by having them show comparisons with the corresponding periods of the preceding year. In fact, the chief criticism of the book is that it distinguishes too much between cost accounting and other accounting, and makes little attempt to show modern methods in general accounting. Sometimes the author dismisses such subjects by saying, as on page 117, "such matters are purely commercial, and for information respecting them, some authority on commercial accounting should be consulted."

The author reduces all cost methods to three, which he calls A, B and C respectively. On page 315, he says: "Departmentalization is the key to accuracy in costing, and the peculiar merit of method C is that it carries the principle of departmentalization as far as the production centers themselves, that is to say, to the ultimate limit possible. It is this that makes it the most accurate of all systems * * * this ultimate simplicity is already reached for practical purposes when a department contains only machines of practically the same cost, size and call on service. When that is the case, further departmentalization is unnecessary. Method A will give accurate results if wages are uniform throughout the shop, and method B will take its place if wages or earnings per hour are not uniform." On page 119, the author summarizes the three methods. He says that they are in fact three degrees of definiteness in the charging of direct labor and expense to product. In method A, both are averaged and reduced to a single charge per period, which may be a whole month but is more commonly an hour. In method B he eliminates the averaging as regards direct labor, but retains it as regards expense. In method C, which is the one that he designates as the most accurate of all systems, the averaging method disappears altogether, and each order is charged with an exact quantity of expense, which analysis shows is its rightful share. This analysis shows that each indirect service to production is really a service rendered to a machine. By calculating the total of all services chargeable to a particular machine, an hourly charge for the use of the machine is obtained. It follows that if a machine is idle part of the time, the case is exactly equivalent to paying a man wages and allowing him to stand idle. Method C, which the author proposes in this and preceding volumes, makes it possible to calculate in dollars this loss due to idleness of machines. He thus secures the cost of manufacturing capacity that has not been used. In some cases this amount can be charged oft to profit and loss. In most cases, however, it is better to pro-rate it over the actual machine charges to each order as a supplementary rate.

The book is an exceedingly helpful one, and it seems captious to criticize its printing, but subsequent editions should be more carefully proof-read than the present one.

It is open to question whether the author is wise in attempting to teach or explain the theory of double-entry bookkeeping in a few words, as he does attempt it in chapter 2 of part 1. Incidentally, the scheme of having the chapters run numerically within each part, rather than numerically throughout the book, does not seem to be a good one, since every reference to a chapter number must contain also a reference to the part. Experience has shown that the theory of double-entry bookkeeping cannot be explained in a few words so that one unfamiliar with it can grasp it sufficiently well to follow the intricate transactions of cost accounting. This is particularly true when the author departs from the usual terminology and shows forms of cashbooks and journals which are not met with in practice. The author's distinction between accounting and bookkeeping is not very enlightening, but his distinction between journals and books of original entry is puzzling and certainly must be misleading to a student who is trained to regard the journal as a book of original entry. The whole idea of trying to explain "the mechanism of accounting" is of doubtful value in a book of this character. When on page 151 the author introduces a form of cashbook (which he calls a cash journal), it would seem preferable to conform to modern accounting practice so far as it is at all standardized. This form contains much analysis which should appear in a purchase journal or voucher record, and not in a cashbook. On page 196 the author, while properly considering depreciation as a reduction of fixed assets, would have us credit the asset accounts themselves. This is not in accordance with usual accounting practice. Neither is his suggestion on pages 34 and 235 that administration expense be divided between factory and selling departments. These criticisms should not in any way deter one interested in the large problems of cost accounting from reading the book. It is a scholarly and complete treatise, setting forth most of the fundamentals of cost accounting, and describing in detail the author's well known suggestion concerning supplementary rates.

HAROLD DUDLEY GREELEY.

VALUATION, DEPRECIATION AND THE RATE-BASE; by CARL EWALD GRUNSKY, Eng. D. *John Wiley & Sons,* New York. 387 pp. $4.00 net.

The general theory of rate-making for public utilities is simple enough. A fair and just rate for both consumer and owner is one that includes (1) the operating expense, (2) taxes, (3) a provision to provide funds for replacing plant and equipment as they wear out and (4) a fair return on the fair value of the property devoted to public service. The first three elements are unquestionably requisite and readily ascertainable. The fourth is equally needful if private capital is to be interested; but the questions of what constitutes a fair return and of how the fair value of the property is to be ascertained have engrossed the attention of courts and commissions for many years; and many periodical articles and books have been written in the effort to find some general method of solution which shall be fair to all concerned. The latest of these books is by Dr. Grunsky, who writes from the experience of a private engineer and public officer (he was at one time civil engineer of San Francisco). It deals very comprehensively with the fundamentals of valuation and rate-making for public utilities. How valuations are made (based on historical cost, reproduction cost, etc.), the proper treatment of accrued depreciation, methods of providing for future depreciation, the correct bases for fixing rates are explained and discussed. The author has his own pet theories to advocate—most writers have—which seem to be somewhat in the nature of a compromise and will command the thoughtful interest of students of the subject. It would be unfair to author and reader to attempt a condensation of the most important of these theories, but the reader will find the unlimited life method as affecting both valuation and depreciation well worth discussing, whether he agrees with the author or not.

In the chapter on *The Accounting System* the author claims that the unlimited life method greatly simplifies bookkeeping in respect to depreciation for the reason that as the plant and property accounts will always be kept at original investment figures (additions and withdrawals duly accounted for) the replacement account will take care of all entries on account of depreciation. (Dr. Grunsky has inadvertently reversed the order of procedure for handling this account, and we know it better by its true name of "reserve for depreciation"). But this is rather academic, because all utilities are obliged to follow the rules for accounting as laid down by the commissions, rules which Dr. Grunsky quotes in extenso. And while theoretically it does seem wasteful of time and ink to take a unit from a given account only to restore it by another entry, in practice it is not a bad thing to keep the utility accountant on the alert watching his property accounts. It is in the neglected or ignored property accounts that items sometimes get hopelessly lost. A chapter by C. E. Grunsky, Jr., E.M., on the valuation of mines and oil properties, deals with the added complication caused by "wasting assets" peculiar to that class and serves as a complement to the general work. It is not possible within the limits of a chapter for Mr. Grunsky to give more than a general survey, but a good bibliography will guide the student who wishes to go deeper into the subject.

Primarily intended for the engineering profession, the book will nevertheless be useful and instructive to accountants interested in public utilities, if only for the excellent tables showing rates of depreciation prevailing in public utilities, annuities for amortizing depreciation, remaining values, etc. W. H. L.

UNIFIED ACCOUNTING METHODS FOR INDUSTRIALS, by CLINTON E. WOODS. The Ronald Press Co., New York. $5.00.

One of the minor results of the world-war will be a wide and far-reaching extension of the principles and practice of cost-accounting for industrials. Not only will industrials undertaking government contracts be forced under the limited-profits clause to ascertain and show their exact costs per unit, but the excess-profits tax will compel all to adopt methods which will enable them to prove to the federal tax assessors just what their real profits may be. Unconsciously those accountants who have of late years been devoting study to cost-accounting have been preparing themselves to perform important duties to country and clients. Those who have not are very much in the position of thousands of patriotic young men who aspire to serve their country as officers—they must now bestir themselves to learn the duties of officers or else be content to accept humbler places in the ranks.

To those desiring to make this eleventh-hour preparation comes a very timely book by Clinton E. Woods. While Mr. Nicholson's work is universally accepted as standard by the profession, Mr. Woods' book is by no means to be regarded as superfluous. Probably a good two-thirds of the book may be said to have been written for the industrial or efficiency engineer, but one does not have to read very far to discover that the accountant must play a great part in order to make the system a success. Indeed, the latter is so indispensable at every step that it would be easier for an intelligent accountant, given the requisite authority, patience and tact, to instal a cost-finding system by his own efforts than for an industrial engineer to do without the aid of the accountant. The ideal method, of course, is for the two to work hand in hand, and in the case of large industrial plants such course is preferable. But with this book as a guide it should not be difficult for a skilled accountant of a small plant to instal a good working system.

Books of this type are so familiar to the profession in these days that it is hardly necessary to describe its contents more than to say it begins at the bottom with the purchase of raw materials and carries the reader through to the finished product ready for sale, giving much detail of practical methods and records throughout the processes of manufacturing. Four chapters deal competently with general accounting, and a specimen set of directions for taking an inventory is a valuable feature. A full fifth of the volume is given to a very complete set of forms including a classified list of stores arranged on the Dewey decimal system.

Chapter II is particularly interesting for its analysis of a specimen balance-sheet from the differing standpoints of the financier, the executive and the manufacturer. Few men know how to read a balance-sheet telligently—that is, to deduce correctly from the figures the current history, the present standing and the probable tendency of a business. While the application of such ability is not restricted to cost accounting, it is valuable in establishing the preliminary general facts, the causes of which may then be sought in the cost statistics. This is a truism, to be sure, but we are much mistaken if the perusal of this chapter by many a manufacturer would not promptly convert him to the advantages of a good cost-accounting system.

As intimated above this is an unusually opportune time for accountants to specialize in cost accounting, and this book is well worth a place on the shelf by the side of Mr. Nicholson's standard work. In many ways the two will be found to complement each other.

W. H. L.

RUBBER COMPANIES' ACCOUNTS; by R. S. STEWART and F. C. EBBELS. *Gee & Co.*, London.

A first and important attempt to establish a standard and uniform system of accounts for a great industry which is conducted far from home, this book is recommended to the profession as a good example of "how to do it." The first thing that strikes the reader's favorable attention is that the book is a joint production of the accountant and the manager. He feels that he is not dealing with theory alone nor even with a book written from a single point of view. A man looking through a pair of binoculars with one eye closed observes that the distant object does not appear quite the same as when he uses both eyes. Just so the professional accountant views a system of accounts from a slightly different angle from that of the manager. When the two can join forces and produce an harmonious picture the result is bound to command the confidence of directors and stockholders. The reviewer feels he is not competent to pick flaws in methods advocated, even though the authors modestly disclaim infallibility and put forth the book merely as an attempt to blaze the trail toward a standard uniform system; but he may at least confess entire satisfaction with the idea of a production made jointly by the man who directs and the man who records.

In the future American capital is likely to be invested largely in similar enterprises in the Philippines and the West Indies, and the ambitious young accountant who looks forward to employment or practice on large plantations will do well to give this book serious study.

W. H. L.

Ohio State Board of Accountancy

As a result of the November, 1916, examination for the degree of certified public accountant, the following men have received certificates authorizing them to practice as certified public accountants in Ohio:

F. A. Hamilton, Cincinnati, Ohio; C. B. Adams, St. Louis, Missouri; Geo. D. Bailey, Detroit, Michigan; J. J. Miller, Cleveland, Ohio; H. C. Royal, Cleveland, Ohio; R. F. Marburger, Pittsburgh, Pa.; W. D. Wall, Columbus, Ohio; R. F. Bishop, Columbus, Ohio; W. J. Semple, Cleveland, Ohio; L. D. Burnell, Detroit, Michigan.

It is announced that Robert H. Eaton, C.P.A., and Charles W. Saussy, C.P.A., have taken over the business of the Eaton-Saussy-Baldwin Co., Inc., and will practise accountancy under the firm name of Eaton & Saussy, certified public accountants, with offices in the National Bank building, Savannah, Georgia.

George L. Vannais, C. P. A., announces that he has opened an office at 252 Asylum street, Hartford, Connecticut, for the practice of public accounting.

Searle and Nicholson, certified public accountants, 52 Broadway, New York, announce the admission to partnership of Thomas R. Lill, C.P.A., (N. J.)

J. E. Graef & Co. announce the removal of their office to the National Bank of Commerce building, Nassau and Cedar streets, New York.

The offices of Theodore Wachtell, C.P.A., have been removed from 170 Broadway, New York, to 309 Broadway, New York.

Charles H. Wright, C.P.A., of Boston, has removed his office from 89 State street, to room 607, 53 State street.

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American Institute of Accountants

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1916-1917

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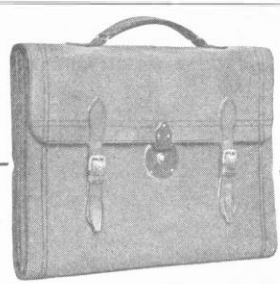

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