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# THE JOURNAL OF ACCOUNTANCY

DECEMBER, 1916

VOLUME XXII

NUMBER 6

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Editorial

Income Tax Department

Students' Department

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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.

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# The Journal of Accountancy

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in the United States of America

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## Depreciation and Value of Public Utilities

BY CHARLES C. JAMES

A farmer invests \$5 in pullets by way of starting himself in the business of producing eggs for the market. For each pullet he pays \$1, getting five for his money. Now hens lay ten dozen eggs every year for five long years, and after that they lay no more, neither are they good for other purposes, being entirely too old, even to stew. Certain critical farmers and poultry raisers may take issue with this statement, but the criticism is technical and beside the point, and we shall ignore it.

Eggs sell for 25 cents a dozen, and it costs \$2.25 a year to keep a hen, so at the end of the first year our farmer has sold 50 dozen eggs for \$12.50 and paid out \$11.25 for expenses, leaving him \$1.25 in hand. Being a far-sighted individual, he takes stock of his finances in a broader way than merely to count hens and dollars on hand. He estimates that each of his hens has one year less to live than when it was a pullet, and for this reason is less valuable. One year gone out of five means that each is one-fifth less valuable; i. e., \$1 (the original cost of each hen) divided by five years (the life of each hen), means that each hen-year is worth 20 cents. The five hens have depreciated 20 cents each, and of his \$1.25 on hand he finds that 25 cents represents profit and \$1 a partial liquidation of his original investment.

Certain college professors would tell him that this \$1 does not belong to him or to his hen business, but is a trust fund that must be placed in escrow, kept separate from the hen business and called a depreciation fund. But this is not so.



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Part of his capital goods has been consumed in producing consumption goods, which in turn have been converted into money. To keep his capital intact, enough of that money to equal the cost of that part of the capital goods that has been consumed should be reinvested in the hen business—not tied up in a stocking and put under the mattress, nor even turned over to a savings bank to earn  $3\frac{1}{2}$  per cent. compound interest as long as more productive use for the money can be found in the business. So our farmer buys another hen for his dollar and spends his 25 cents profit, which is 5 per cent. on his original investment, in riotous living.

The second year he secures from his six hens 60 dozen eggs, which he sells for.....	\$15.00
His expenses for the six hens, at \$2.25 each, are.....	13.50
Leaving for depreciation and profit.....	\$1.50
As he has six hens on which to set up depreciation, based on a life of five years for each hen, his depreciation charge must be.....	1.20
He has left a profit of.....	\$0.30
Per cent. of profit.....	6

He now has \$1.20 to reinvest in the business—and here we come face to face with a complication that spoils the beauty of our problem, but in doing so it is not different from the complications that arise wherever else the question of depreciation has to be considered. Our farmer cannot reinvest his entire accrued depreciation in hens, since hens do not sell in fractions, so he buys one additional hen at \$1 and is compelled to hold 20 cents in the treasury idle, just as every business is compelled to hold dormant, or nearly so, a part of its resources, which, if dollars could be earmarked, would in many cases be found to be part of its depreciation fund.

The second year our farmer secures from his seven hens 70 dozen eggs, which he sells for.....	\$17.50
His expenses for the seven hens at \$2.25 each, are....	15.75
Leaving for depreciation and profit.....	\$1.75
Depreciation is .....	1.40
He has left a profit of.....	\$0.35
Per cent. of profit.....	7

### *Depreciation and Value of Public Utilities*

He now has on hand in his depreciation fund \$1.60, but from this he can again buy only one additional hen, leaving 60 cents to lie idle.

The fourth year he secures from his eight hens 80 dozen eggs, which he sells for.....	\$20.00
The expenses for the eight hens at \$2.25 each are.....	18.00
	<hr/>
Leaving for depreciation and profit.....	\$2.00
Depreciation is .....	1.60
	<hr/>
He has left a profit of.....	\$0.40
Per cent. of profit.....	8

The tabulation on page 412 shows how the transaction works out during a period of twelve years. After that time the yearly results alternate between those of the eleventh and those of the twelfth years.

Each year our farmer has taken stock of his enterprise and has conserved out of income enough to keep the original money investment intact. This is sound finance and must always be the first consideration in any enterprise. Many good accountants have maintained that our farmer would be justified in spending a part of his depreciation fund during those years when the rate of return was below the average because there would come years when it would be above the average, when he could make up the deficiency. But this is not sound in principle or practice and probably will some day be declared unlawful.

In order clearly to understand the significance of the fact that the rate of return on the money investment is not constant in company with the value of the investment itself, which must be kept constant, let us digress here to consider a few fundamentals:

The capital investment in any enterprise is measured in dollars and cents, first for the purpose of the exchange that takes place when the industry is acquired, and second for the purpose of stating the investment in the accounts, so that we have come to think of invested capital in terms of money; but fundamentally this is dealing with the shadow and overlooking the substance. Invested capital, in the true sense of the word, is not money,

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	1st year	2nd year	3rd year	4th year	5th year	6th year	7th year	8th year	9th year	10th year	11th year	12th year
Production of eggs (dozen).....	50	60	70	80	100	70	70	80	80	80	70	80
<i>Year's Income:</i>												
Receipts .....	12.50	15.00	17.50	20.00	25.00	17.50	17.50	20.00	20.00	20.00	17.50	20.00
Expenses .....	11.25	13.50	15.75	18.00	22.50	15.75	15.75	18.00	18.00	18.00	15.75	18.00
Net .....	1.25	1.50	1.75	2.00	2.50	1.75	1.75	2.00	2.00	2.00	1.75	2.00
Depreciation .....	1.00	1.20	1.40	1.60	2.00	1.40	1.40	1.60	1.60	1.60	1.40	1.60
Net profit .....	.25	.30	.35	.40	.50	.35	.35	.40	.40	.40	.35	.40
Per cent. of profit.....	5	6	7	8	10	7	7	8	8	8	7	8
<i>Annual additions and retirements of capital: (hens)</i>												
Number at beginning of year.....	5	6	7	8	10	7	7	8	8	8	7	8
Number retired .....	.	.	.	.	5	1	1	1	2	2	1	2
Number acquired through investment of depreciation set aside.....	5	6	7	8	5	6	6	7	6	6	6	6
Number at end of year.....	1	1	1	2	2	1	2	1	2	1	2	1
<i>Depreciation accrued:</i>												
Balance uninvested at beginning of year	1.00	1.20	1.40	1.60	2.00	1.40	1.40	1.60	1.60	1.60	1.40	1.60
Amount accrued .....			.20	.60	.20	.20	.60	.60	.60	.20	.80	.20
Total .....	1.00	1.20	1.60	2.20	2.20	1.60	2.00	1.60	2.20	1.80	2.20	1.80
Amount invested in additional hens....	1.00	1.00	1.00	2.00	2.00	1.00	2.00	1.00	2.00	1.00	2.00	1.00
Balance at end of year.....	.	.20	.60	.20	.20	.60	.	.60	.20	.80	.20	.80

### *Depreciation and Value of Public Utilities*

but hens, or trolley-cars, or ferry-boats or anything else in the way of production goods devoted to the purpose of turning out consumption goods.

The productiveness of capital goods is a physical affair, so that while we say from the standpoint of sound accounting that a hen whose egg-laying life is half gone is worth only half what it was when its egg-laying life began, yet this conclusion is in no wise based upon the physical productiveness of the hen, which may still lay just as many eggs and just as good eggs as it did when it was a pullet. No one would think of contending that old hens' eggs should sell for less than young hens' eggs, yet this was just what the interstate commerce commission said when it came to determine the rate which should be charged ferry passengers for crossing the North River on an Erie ferry-boat.\*

North River ferry-boats are very unlovely craft, and no stretch of the imagination could bring one to think of them as providing a service de luxe that would justify a charge proportioned to the elegance of the appointments provided. Longitudinal wooden benches on two decks accommodate as many individuals as it is possible to provide with seats, and the vacant spaces between and about these benches allow standing room for the remainder. As long as these boats are kept reasonably clean and their machinery is maintained in such shape as to propel them back and forth across the river at a handsome rate of speed, their service duty is fulfilled; yet the interstate commerce commission has said that the rates that are fair for riding on a new ferry-boat which cost \$150,000 must be reduced when after a few years the railroad has conserved from its ferry-boat earnings a proportion of the original cost of this boat and reinvested the money—perhaps by buying box cars to carry wheat and other articles to feed the commuters between trips. The commission would probably hold, following the same line of reasoning, that the freight rates on the wheat and other commodities should be reduced after the cars that were acquired by the reinvestment of the ferryboat depreciation fund have in turn become depreciated and the box-car depreciation fund has been reinvested in still other property.

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\*37 I. C. C. rep. 103.

As long as the service is unimpaired, this is erroneous doctrine. What the buyer of eggs, or the ferry-boat passenger or the shipper is concerned with is the character of the consumption goods that his money pays for, and this does not vary directly with the cost of the production goods utilized in serving him. An egg is an egg, for eating purposes, if it is fresh, whether it came from a pullet or an old hen, or whether it was laid by the scrubbiest of hen stock or the fanciest of high-grade poultry. A ferry-boat ride is the same whether the boat be old or new, whether the steel of her hull was bought at panic prices or at the top of a wartime market. And so with the transportation of a carload of wheat.

The price of any of these, if unregulated, would be determined by how much the public could afford to pay.

Where several enterprises are competing in a common market their competition reduces the price of their output below what the public would otherwise have to pay, but never reduces it, except temporarily, below the point where the rate of return is attractive for all of the enterprises that remain in the business—that is to say, competition results, in the long run, in making of every industry it affects an attractive field, but only for shrewd investment and efficient management. Collaterally, the value of any enterprise engaged in competitive industry is determined by its relative earning power.

When public regulation enters the field, as it does in the case of public utilities, it assumes the function of competition.

When determining prices, which in turn determine the profitability of the industry, which in turn determines the value of the industry, if competition reduces the price of any commodity to a point where the capital devoted to producing that commodity yields a rate of return less than capital of an equal cost would yield in other industries, the element of risk duly considered, then investors avoid the field of production of that commodity and go elsewhere with their money. The same result occurs where the reduction in price is brought about by public regulation.

That capital will avoid unproductive fields and go elsewhere has been clearly demonstrated on a large scale in the case of the railroads, whose unprofitableness in comparison with other fields of industry has been clearly evident for some years—whether the

### *Depreciation and Value of Public Utilities*

cause be excessive competition, reckless financing or unwise public regulation. As a result, we find that last year less railroad construction was undertaken than in any other year since the civil war.

Yet in a large measure courts and commissions, ignoring this economic limitation to their powers, have come to exercise their functions as though they were dealing with conditions entirely in a world of their own making. Too often they have taken an arbitrary percentage, determined upon subjectively, and applied it to an approximate physical valuation to arrive at what they called a fair rate of return.

Not infrequently they have taken the average rate of return on the market prices of public utility bonds as a true measure for the proper ratio of net income to physical value of public utilities, not recognizing the fact that this overlooks entirely the necessity that exists in all business of rewarding those who make industry possible.

In the world of finance, a corporation obtains funds for property investment in only two ways aside from surplus earnings. It may borrow money and may call on its stockholders for it. If borrowed, and it can borrow only a part, an underwriting fee must be paid, and there must be some margin of profit allowed between the interest paid and the profitableness of the property acquired, else there is no inducement in the undertaking. If its bonds pay five per cent. to the investor, the interest paid by the company (treating discount and underwriting expenses as being tantamount to interest) will probably be a considerable fraction more than five per cent., and the earning power of the property acquired must be even more than this. As to that part that the stockholders provide, there is no saving, for they will not put money into the business unless the promised rate of return be considerably more than a fair bond interest rate—unless, in fact, their money will earn as much here as anywhere else—in making steel, or mining coal or doing any one of the other things that money will do in the best of the fields that are open to it.

Accordingly, until comparisons are made between the profitableness of public utilities and the profitableness of other enterprises, and rates are regulated to place the two on a level where they will equally attract capital, we can have no permanent and

## *The Journal of Accountancy*

sound solution of the question of reasonable rates. This prime requirement must govern whether we are to go forward on the established policy of dealing with public utilities as private property, or are to take up the new-fangled paternalistic doctrine that they are merely agencies of the state performing a public service at a guaranteed rate of return during good behavior.

Nor is the theory sound that once capital is devoted to public utility purposes it is caught in a net, cannot escape and so may be treated as ruthlessly as desired, short of plain confiscation. While this is morally wrong, yet to a large degree it might succeed in individual cases, but it is not a policy of wisdom in a country like the United States, where development is only half complete. The facilities already provided are scarcely sufficient for the present day and will continue to become less so as the business of the country expands. The common progress can go no faster than the entire procession moves, and when any part ceases to go forward the entire procession is impeded.

Here, then, we may return to the consideration of depreciation. Like all other factors, it should be given the same weight in the administrative regulation of public utilities as similar factors may be found to have in determining the profitableness of enterprises affected only by competition.

This conclusion does not disregard the fact that the court of last resort has held that the constitutional prohibition against confiscation throws no protection beyond the depreciated value of property.\* As the interstate commerce commission has well said: "A rate or fare that is merely non-confiscatory may fall short of one that is entirely just and reasonable."†

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\*230 U. S. 352, 411.

†30 I. C. C. 352, 355 and 37 I. C. C. 627, 635.

# Industrial Accounting

## VII.

BY F. J. KNOEPEL, C.P.A.

“One of the tasks of modern scientific management, of efficiency and standard practice engineering—two names for the same ideals—is to convert efficiency records into cost records, since the language of costs is understood by all, the language of efficiency only by the few. . . .”

“In the refinement essential to the control of modern operations, it becomes increasingly necessary to state efficiencies even if we talk costs.”—Harrington Emerson, in *The Twelve Principles of Efficiency*.

Efficiency is inseparably linked with costs. The purpose of efficiency is to reduce costs. Costs should fall with increased efficiency and rise with decreased efficiency. If we express and view results in terms of efficiency alone, as is often the case, we may find ourselves guilty of a “penny wise, pound foolish” policy; and if we deal with cost variation and excess alone, we shall be without a trustworthy index to relative results and progress.

Activities may show low rates of efficiency and apparently merit serious attention when, in fact, the cost involved under an activity may be so small as to render any possible saving a matter of minor consideration. It is, of course, desirable to reduce all inefficiency to a minimum, but not to eliminate the small wastes before we attack the larger losses.

The fact that operation A is 74 per cent. efficient and operation B is only 52 per cent. efficient does not indicate that maximum efficiency under operation B would effect a greater saving than 100 per cent. efficiency under A. If the operating cost of A is \$1,000, and of B \$100, it obviously would be more important to attack the inefficiencies surrounding A.

Efficiency percentum relates relative accomplishment and progress.



## *The Journal of Accountancy*

Cost of accomplishment indicates the significance of the expressed efficiency.

Efficiency must be viewed as an aid to conservation and economy. "Hitting the high spots" may be condemned by some, but these same high-spot-losses returned to the treasury give increased working capital and often provide the means and encouragement to attack the lesser inefficiencies.

Failure to obtain the results hoped for in efficiency work, and through constructive costing, in many instances may be charged to a lack of appreciation, on the part of those engaged, of the vital bearing of operating cost to productive efficiency. Lack of progress after the installation of efficiency methods is quite often due to failure to provide the management with a form of report that will clearly show what is being done and where the greatest corrective effort should be applied.

We may measure efficiency either upon the basis of accomplishment or requirement.

Accomplishment—what was done within a given time—may be expressed:

A = Actual amount of work done,

S = Standard (possible) amount,

E = Efficiency,

I = Inefficiency

$$(1) E = \frac{A}{S}$$

$$(2) I = \frac{S - A}{S}$$

Proof: A=100 pieces; S=150 pieces

$$(1) 100 \div 150 = 66\frac{2}{3}\% \text{ efficiency } E$$

$$(2) 150 - 100 = 50$$
$$50 \div 150 = \frac{33\frac{1}{3}\% \text{ inefficiency } I}{100\%}$$

## *Industrial Accounting*

Requirement—time taken, or labor cost to perform a given task—may be expressed:

a=Actual time or labor cost,

s=Standard (possible) time or labor cost,

e=Efficiency,

i=Inefficiency.

$$(1) \quad e = \frac{s}{a}$$

$$(2) \quad i = \frac{(a-s)}{a}$$

Proof: a=30 hours; s=20 hours:

$$(1) \quad 20 \div 30 = 66\frac{2}{3} \text{ efficiency } e.$$

$$(2) \quad 30 - 20 = 10$$

$$10 \div 30 = \frac{33\frac{1}{3}\%}{100\%} \text{ inefficiency } i.$$

Both of the foregoing formulas are frequently the only ones employed in expressing efficiency; largely because upon the percentages so obtained bonus or premiums are paid to the workers, and also because many persons believe efficiency to be concerned only with increasing the output per dollar paid to labor. All premium or bonus to workers should be based solely upon such formula. Cost (economy) efficiency is not, strictly speaking, within the control of the worker, but dependent upon proper supervision and management.

Efficiency of accomplishment or requirement does not curb strenuous effort, except as penalties are imposed for faulty work.

If efficiency is opposed to strenuousness—and it is—we must be careful that strenuousness is not fostered or indicated as efficiency in our records. This emphasizes the closing contention in the preceding article: that results obtained in departments, or throughout a factory, should not be viewed upon the expressed ratio of working time to standard time alone; that the true net-operating-efficiency is due to conservation of assets as well as to utilization of energy; and, that its correct expression calls for a portrayal of cost (economy) efficiency as well as production (energy) efficiency.

The object of a military campaign may be achieved within the time set, but its cost in life and exhausted resources may be far beyond expectation. So, also, a factory or its operating units may attain to a desired output within a proper time limit or labor cost and be rated 100 per cent. efficient—but, as to activity (production) alone. What about the total cost?

Total cost—the cost of efficiency—is the final test to be applied in judging results. For this reason our cost standards are quite as important as time and output standards. Throughout the grouped presentations given in preceding instalments labor cost was invariably treated as the standard value of labor established for the class and amount of work performed. Groups I and J exhibit the data essential to the correct expression of efficiency.

For purpose of illustration let us consider actual efficiency based upon the following supposed facts:

- (1) Produced 400 hours of work in 500 hours,
- (2) Worked 500 hours of a normal 800-hour capacity,
- (3) Work rated at 25 cents labor cost per process hour,
- (4) Actual overhead \$90.00; standard \$30.

$$(1) \frac{400}{500} = 80\% \text{ efficiency}^*$$

$$(2) \frac{500}{800} = 62\frac{1}{2}\% \text{ efficiency}^{**}$$

$$(3) \begin{array}{l} *80\% \text{ efficiency} = 400 \times 25c. = \$100 \text{—standard} \\ \text{labor cost} \\ **62\frac{1}{2}\% \text{ efficiency} = 800 \times 25c. = \$200 \text{—standard} \\ \text{labor cost} \end{array}$$

$$(4) \frac{\$30}{\$90} = 33\frac{1}{3}\% \text{ efficiency.}$$

Number one is determined under “requirement” formula and two under “accomplishment.”

80% represents efficiency for actual time worked,

62½% represents efficiency of time worked to possible working time.

The net production (energy) efficiency is the product of these two: (80% × 62½% = 50%).

## *Industrial Accounting*

The same result is secured by measuring the actual production (400 hours' work) against the working capacity (800 hours' work); or, as shown by illustration three, by measuring the standard labor cost of work done against the capacity rated in standard labor cost ( $\$100 \div \$200 = 50\%$ ).

This expression is valuable, but incomplete and possibly misleading without a further exhibit of cost (economy) efficiency, as shown under four ( $\$30 \div \$90 = 33\frac{1}{3}\%$ ).

A record, similar to the following, covering every department and activity, should be maintained and closely reviewed. It is the most sensitive indicator with which the management can equip itself.

Efficiency record

Department . . . . .

Monthly (individual):

- (a) Efficiency of actual time worked.
- (b) Efficiency of time worked to possible (capacity) working time.
- (c) Efficiency of (energy) production ( $a \times b$ ).
- (d) Efficiency of (economy) cost.
- (e) Actual overhead cost.
- (f) Actual labor cost.
- (g) Actual operation cost ( $e + f$ ).

Monthly (cumulative)

(Same detail as monthly, individual).

\* \* \* \* \*

We may now take up the remaining groups in order, as they are largely self-explanatory.

Group K. Exhibit of total cost applied on production, betterments and maintenance. Made up in the accounting department. Arranged for monthly comparison.

(1) Production:

- (a) Material (from group R)
- (b) Labor and factory overhead (from group D)
- (c) Supplies (from group E)
- (d) Expense (from group F)
- (e) Total of a, b, c and d.

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- (2) Betterments:
  - (a) Material (from group S)
  - (b) Labor and factory overhead (from group D)
  - (c) Supplies (from group E)
  - (d) Expense (from group F)
  - (e) Total of a, b, c and d.
- (3) Maintenance:
  - (a) Material (from group S)
  - (b) Labor and factory overhead (from group D)
  - (c) Supplies (from group E)
  - (d) Expense (from group F)
  - (e) Total of a, b, c and d.
- (4) Summary:
  - (a) Total production 1e (to group L)
  - (b) Total betterments 2e (to group L)
  - (c) Total maintenance 3e (to group L)
  - (d) Total of a, b and c.
- (5) \*Ratio:
  - (a) % Production to total cost
  - (b) % Betterments to total cost
  - (c) % Maintenance to total cost
  - (d) 100% Total of a, b and c.

\*Ratio should be closely watched from month to month, as it has a direct bearing upon working capital.

The accounting department in preparing all the data for presentation must transfer the values under 4a, 4b and 4c to group L.

No general ledger entries are required.

\* \* \* \* \*

Group L. Review of conditions and tendencies.

Made up in the accounting department.

Arranged to furnish a final summarized exhibit of all the industrial accounting groups presented in these articles. All groups are interlocking and data should be carried through the various group reports, until a final report is obtained under group L, where the values must be in proper balance to prove the correctness of the cost accounting.

### *Industrial Accounting*

- (A) Factory cost:
- (1) Applied on production (from group K)
  - (2) Unapplied service cost (from group H)
  - (3) Unapplied factory overhead (from group J)
  - (4) Unapplied material cost (from group R)
  - (5) Total cost (sum of 1, 2, 3 and 4)
- (B) Work in process:
- (1) Unfinished piece operations (from group N)
  - (2) Unfinished piece lots (from group N)
  - (3) Partly completed sections (from group O)
  - (4) Total in process (sum of 1, 2 and 3) (to group M)
- (C) Sales:
- (1) Selling price of all contracts completed to date  
(from group P)
  - (2) Selling price on partly completed contracts to date  
(from group O)
  - (3) Total sales (sum of 1 and 2)

(D) Operating profit:			
Sales (C)		\$xx.xx	
Deduct:			
Factory cost (A)	\$xx.xx		
Plus in process at close of previous month	\$xx.xx		
Total	\$xx.xx		
Minus in process at close of current month (B)	\$xx.xx	\$xx.xx	
Net operating profit		\$xx.xx	
Add: Labor cost saving through bonus (from group A)		\$xx.xx	
*Actual operating profit		\$xx.xx	

\*The resultant under actual operating profit should prove in practical balance with the operating (manufacturing) profit shown under group M.

Data under B4, must be transferred to group M.

No general ledger entries are necessary.

A review of group L in connection with chart IV will indicate how the "factory, or manufacturing, profit and loss statement" is constructed without reference to the general ledger.

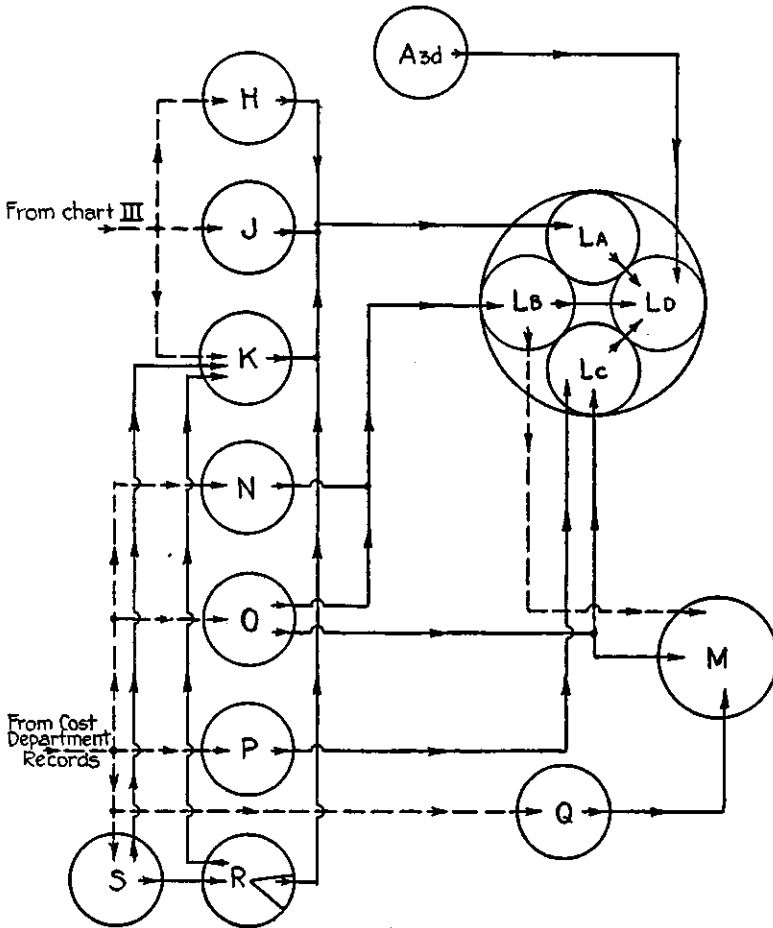


CHART IV

Note ! Sector in R indicates unapplied material cost

The method of preparing cost data for proof through the general accounting books has been considered, and group L shown as presenting a statement of gross manufacturing profit. Such statement of gross manufacturing profit is made up of

## *Industrial Accounting*

data secured from other group representations; is entirely independent of the general accounting books; and, if in balance with the result secured through the general ledger trial balance, constitutes a positive proof of accurate cost accounting performance.

The construction of group L was clearly shown on chart IV. A review of this chart will render it quite clear that, after all data under each group have been properly presented, and the necessary transfer of data has been made, two groups only (L and M) carry unbalanced values. These two groups then remain to be disposed of, all other groups having been, so to speak, closed out or balanced off into other groups. Viewing the various groups as accounts, M may be considered as a controlling account, with L as the final balancing account of the controlled group of accounts.

Group M is simply an intelligently arranged trial balance of the general accounts, with provision for the including of the necessary inventory values.

\* \* \* \* \*

Group M exhibit of resources, liabilities, net investment and earnings.

Made up in the accounting department from the general ledger accounts, and certain data drawn from groups L, O, Q and R.

### (A) RESOURCES

#### (a) Treasury:

- (1) Cash and bank
- (2) Trade debtors
- (3) Notes receivable
- (4) Employees
- (5) Guaranty bonds

Total treasury assets.



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(b) Inventories:

In-process

- (a) Partly completed contracts  
(from group O)
- (b) Cost of production in-process  
(from group L)
- (c) Cost of betterments in-process  
(from group Q)

Total in-process inventory

- (2) Raw materials
- (3) Prepared materials
- (4) Kiln coal
- (5) Power coal
- (6) Miscellaneous

Total inventories.

(c) Property:

- (1) Land
- (2) Plant
- (3) Miscellaneous
- (4) Reproductive value (sum of 1, 2 and 3)
- (5) Reserve for restoration (negative asset)
- (6) Sound value of property (4 minus 5)

(d) Outside investments:

- (1) Stocks
- (2) Bonds

Total outside investment

(e) Deferred charges

- (1) Taxes
- (2) Insurance

Total deferred charges

Total resources, (sum of a, b, c, d and e)

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(B) LIABILITIES

(a) Current:

- (1) Trade creditors
  - (2) Notes payable
  - (3) Advances on contracts
  - (4) Accrued wages
  - (5) Accrued salaries
  - (6) Unpaid commissions
- Total current liabilities

(b) Constant:

- (1) Bonds
  - (2) Loans
- Total constant liabilities

Total liabilities (a plus b)

\*(c) Net investment (A minus B)

(C) NET INVESTMENT

- (a) Capital stock
- (b) Surplus
- (c) Dividends unpaid
- (d) Anticipated return on fixed capital
- (e) Profit for current year

\*Total net investment. \*Must be in balance with above.

(D) EARNINGS

(a) Sales:

- (1) Completed work
  - (2) Partly completed contracts (from group O)
- Total sales

(E) MANUFACTURING COST

(a) Payroll:

- (1) Productive labor
  - (2) Saving through bonus (negative)
- Net productive labor (1 minus 2)
- (3) Non-productive labor
  - (4) Shop salaries
  - (5) Non-shop salaries
- Total payroll cost

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(b) Materials and supplies:

- (1) Raw
- (2) Prepared
- (3) Miscellaneous  
(detail)

Total materials and supplies used.

(c) Expense:

- (1) Insurance  
(detail)
- (2) Taxes
- (3) Incidental

Total expense

(d) Capital cost:

- (1) Depreciation
- (2) Interest on investment

Total capital cost

Total manufacturing cost (sum of a, b, c and d)

Deduct: Cost of completed betterments

Net manufacturing cost

(F) CONDITION OF INVENTORIES

(a) Opening inventory:

- (1) Work in-process (from group L)
  - (2) Betterments in-process (from group Q)
- Total opening inventory

(b) Closing inventory:

- (1) Work in-process (from group L)
  - (2) Betterments in-process (from group Q)
- Total closing inventory

(c) Decrease in inventory (a minus b)

(d) Increase in inventory (b minus a)

(G) ADMINISTRATION EXPENSE

- (a) Executive salaries
- (b) Office salaries
- (c) Etc., etc.

Total administration expense

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- (H) SELLING EXPENSE  
(Detail)
- (I) FINANCIAL GAIN
  - (a) Interest earned
  - (b) Discounts on purchases
  - (c) Miscellaneous
  - Total financial gain
- (J) FINANCIAL LOSS
  - (a) Interest cost
  - (b) Discounts on sales
  - (c) Miscellaneous
  - Total financial loss

SUMMARY

*Condensed operating statement*

(A) Total sales (from D)		\$xx.xx
(B) Manufacturing cost (from E)	\$xx.xx	
Adjustment of above (from F)	\$xx.xx	\$xx.xx
(C) Operating profit (A minus B)		\$xx.xx
(D) Administration expense (from G)	\$xx.xx	
Selling expense (from H)	\$xx.xx	\$xx.xx
(E) Profit through sales (C minus D)		\$xx.xx
(F) Financial gain (from I)	\$xx.xx	
Financial loss (from J)	\$xx.xx	\$xx.xx
(G) NET PROFIT (E minus or plus F)		*\$xx.xx

\*Transfer net profit to section C, item e, under net investment, group M.

\* \* \* \* \*

Group N exhibit of applied cost on unfinished work on floors.  
Made up in the cost department  
Prepared monthly and arranged departmentally.

1. Applied cost on unfinished piece operations
  - (a) Labor
  - (b) Burden or overhead
  - (c) Total (a plus b) (to group L)

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2. Applied cost on unfinished piece lots:

(a) Factory cost (to group L)

3. Total (1 plus 2)

Values appearing under 1c and 2a must be transferred to group L.

No general ledger entry is required.

\* \* \* \* \*

Group O. Exhibit of applied cost on partly completed work.

Made up in the cost department.

Arranged to show by production order numbers the cost condition of all partly completed orders.

1. Partly completed sections:

(a) Factory cost

(c) Sundry cost

(c) Total (a plus b) (to group L)

2. Partly completed contracts:

(a) Estimated cost

(b) Factory cost

(c) Sundry cost

(d) Total cost (b plus c)

(e) Selling price (pro-rated) (to groups L and M)

(f) Loss (d minus e)

(g) Gain (e minus d)

Value appearing under 1a must be transferred to group L, and value under 2e to groups L and M.

No general ledger entry is required.

\* \* \* \* \*

Group P. Review of completed contracts

Made up in the cost department.

Arranged by contract number and name to cover all contracts completed during the month or period.

(a) Factory cost

(b) Sundry cost

(c) Total (a plus b)

(d) Selling price (to group L)

(e) Loss (c minus d)

(f) Gain (d minus c)

(g) Estimated cost

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Values appearing under (a) must be transferred to group L.  
No general ledger entry is required.

\* \* \* \* \*

#### Group Q. Status of betterments.

Made up in the cost department.

Arranged to show the condition of all betterments.

1. In process at close of month or period.
  - (a) Date started
  - (b) Description
  - (c) Account chargeable
  - (d) Order number
  - (e) Estimated completed cost
  - (f) Actual applied cost to date (to group M)
2. Completed during month or period.
  - (a) Date started
  - (b) Description
  - (c) Account chargeable
  - (d) Order number
  - (e) Estimated completed cost
  - (f) Actual completed cost

Value appearing under 1f must be transferred to group M.

Data under 2f would be used for purpose of a general ledger entry:

Debit proper account under 2c (property assets).

Credit betterments completed (factory cost).

\* \* \* \* \*

#### Group R. Variation in material cost.

Made up in the cost department.

Arranged for monthly or periodic determination by main classes of materials.

- (a) Reported on uncompleted work, close of month or period.
- (b) Reported on work completed during month or period.
- (c) Total possible consumption (a plus b).
- (d) Reported on uncompleted work, first of month or period.
- (e) Net standard consumption (c minus d) (to group K).
- (f) Net actual amount consumed (from group S)

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- (g) Actual consumption above standard (f minus e).
- (h) Actual consumption below standard (e minus f).
- (i) Cumulative variation (to group L).

Values appearing under (e) must be transferred to group K, and value under (i) to group L.

\* \* \* \* \*

Group S. Consumption of raw and prepared materials.

Made up in the cost department from storekeeper's record or requisitions.

- (1) Charge for use:  
(detail by material classifications)
- (2) Credit for issuance:  
(detail by storeroom or inventory classifications)

Values appearing under (1) must be transferred to groups R and K. The detail under (1) and (2) will be used for a general ledger entry.

Debit materials (factory cost)

Credit inventories (resources)

\* \* \* \* \*

In concluding these articles it may be well to remark upon the use of the term "industrial accounting." The word industrial is defined as denoting the processes or products of manufacture, or commercial production in general.

Only when the costing is properly reflected through the general accounting, and when costs are secured with regard to processes, products and production, can the methods employed be properly described as an industrial accounting. Cost accounting too often deals solely with the result of factory operations; and—as the word cost is defined as that which is given for a thing in order to procure it, the price paid; outlay; expense; charge—it seems hardly to fill the need.

In view of the efforts being made in the improvement of industrial conditions and relations, and in view of the broadening use of the terms "industrial management," "industrial organization" and "industrial engineering," it seems only proper that the application of accounting principles with regard to these active industrial forces should be termed "industrial accounting."

# Qualifications and Responsibilities of Public Accountants\*

BY J. E. MASTERS, C.P.A.

It is safe, perhaps, to assume that a large majority of educated and well-informed business people have some knowledge of the accounting profession, but it is, however, a fact that this knowledge is more or less vague in the minds of a great many people.

It is not difficult to understand why the accounting profession is not more widely known and understood by the general public when we consider that the total membership of the Institute of Accountants in the United States of America is only about 1,200 and that ten years ago the membership of its predecessor, the American Association of Public Accountants, was approximately half that number. In view of this relatively small number of accountants it is interesting to note that they and their work are as widely known as they are, and it seems fair to conclude that the creditable position occupied by accountancy in the business world is due more to quality than to quantity. In an address at the annual convention of the American Association of Public Accountants held in Boston in September, 1913, the late Francis B. Sears said: "The bankers, the merchants, the manufacturers, all recognize the importance of your work, and each year shows their increasing reliance upon your services." It is gratifying to those of us engaged in the accounting profession, and at the same time impresses us with our responsibilities to hear and read expressions of this kind from those in other walks of life. Perhaps it is well to mention at this point that the term accountant is used as applying primarily to those in public practice and not to the many other classes—for example, those in charge of the accounts of corporations, of governments, etc.

## RESPONSIBILITY OF THE PUBLIC ACCOUNTANT

Taking up the responsibility of the public accountant first will give a general idea of the necessary qualifications and draw attention to the importance of the qualifications. With the rapidly

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\*An address at the opening of the Worcester School of Accountancy and Business Administration, 1916.



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increasing wealth and business of this country in recent years, and the concentration of capital in the development of many important industries, has come increased responsibility for the public accountant. This responsibility may be said to be divided as between those things for which he is responsible and those people to whom he is responsible.

First of all, the accountant is responsible for the faithful, conscientious and efficient performance of his work to a degree which is equaled by few and surpassed by none of the professions. That this is true will be realized when we consider that the failure to carry out his work in strict compliance with the highest ideals and standards of duty may mean the financial ruin of his client and, indirectly, serious loss to those persons dependent, wholly and partly, upon the success of the client.

The legal responsibility of the accountant in this country has not been decided by the courts, but in England there have been many cases by which the legal responsibility has been fairly well determined. While there have been no court decisions of importance bearing upon the subject in this country, the successful practising accountant has not lacked appreciation of his responsibility nor labored any less earnestly to set and maintain as high standards as exist elsewhere.

In the case of the legal and medical professions the responsibility is almost exclusively to the client and the patient, but the public accountant is responsible not only to the client, but also to the general investing public. It is not sufficient for the public accountant to serve conscientiously and efficiently the client who employs him, but he must constantly keep in mind his responsibility to others who are entitled to know the truth and the whole truth appertaining to the client's business. The natural inclination in our associations and dealings with our fellow men is to cater to and befriend the person who brings the grist to the mill, but the accountant's responsibility in many instances requires that he deviate from this kindly and usual course and disclose facts and information contrary to the wishes of the client and, in some cases, at the expense of the client's goodwill. To meet such demands requires the keenest appreciation of the responsibility assumed and absolutely unselfish devotion to duty regardless of

### *Qualifications and Responsibilities of Accountants*

personal sacrifice or possible pecuniary loss, ever keeping in mind that above all else the interests of the client and the public should have the first and highest consideration.

The relations between the accountant and his client are close and confidential. Of necessity the accountant comes into possession of private and personal information regarding the affairs of the client and the business, and his responsibility to guard zealously the information and facts of such confidential and important nature is great. The improper disclosure of confidential information is not only an abuse of confidence placed in the accountant, but may result in immeasurable detriment to the client in various ways.

The utmost discretion on the part of the accountant is necessary in deciding, in many instances, what information should be disclosed and to whom, and it is not always an easy matter to be absolutely certain who is entitled to information and facts of which the accountant comes into possession. For instance, an examination may be made of a concern on behalf of a creditor who may be a competitor, yet is entitled to know the financial position of the concern examined, but it would obviously be unfair to the concern and possibly result in serious loss if other information in regard to the business, such as the names of customers, prices of goods, secret processes, etc., were disclosed to the competitor.

On the other hand, in the case of an examination on behalf of a prospective purchaser of a business, it would in most cases be quite proper to obtain and submit all information as to the characteristics of the business which would be useful to the purchaser in determining the price he would pay or the desirability of the purchase.

In cases where audits and examinations are made primarily for verifying and setting forth to the stockholders of corporations their financial position and the results of operations, the information to be disclosed should be restricted to the material facts and figures necessary to show the true financial position—and again the disclosing of information concerning the company that might be of peculiar advantage to a competitor must be carefully avoided. In deciding what information should be disclosed and

what withheld careful consideration must be given to the question of whether the withholding of certain facts and data may result in misrepresentation of the financial position or results of an undertaking.

In other cases where the accountant's services are desired on behalf of the management only, to assist in the successful conduct of the business, there is usually no restriction in regard to the information appertaining to the business to be disclosed to the management; in fact, the accountant is responsible in many cases for bringing to attention matters which may not be pleasing and criticising the management, should conditions seem to warrant it.

The manner in which the accountant sets forth the results of his audits and investigations is important, since he assumes the responsibility for stating accounts and reporting in ways that will not be misleading, setting forth all material facts upon the situation, at the same time eliminating all unnecessary detail. The client has neither the time nor inclination to wade through a long report, given over largely to uninteresting and possibly irrelevant comments, in order to get a few important points. The accountant is responsible for separating the grain from the chaff, the important data from the irrelevant, and presenting the result concisely but not in unmistakable terms.

It might be thought by those not familiar with the work of the accountant that his responsibility is confined to the mathematical accuracy of figures appearing in books and records under examination, but this is far from the case, as there are other highly important things to be considered. For instance, it might be found that in the books of a concern with wasting capital assets such as buildings, machinery and equipment, the ordinary repairs and maintenance expenditures were charged to these asset accounts and no corresponding charge made against earnings. The amounts might be entirely correct, the books accurately posted and in balance, yet the earnings of the concern and the financial position, as shown by the books alone, would be incorrect; and in an audit of the accounts the accountant is responsible for discovering such conditions. Errors in principle in the keeping of accounts may be quite as harmful in their results as

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dishonesty on the part of those responsible therefor and the detection of such errors is quite apart from the mathematical accuracy of the accounts.

The accountant is responsible, to some degree, for disclosing things that may not appear on the books of the company, whether they are unintentionally or fraudulently concealed. The item of contingent liability is a striking example, as it is often the case that this is not shown in the financial books in any particular account, the proprietor having overlooked or not appreciated the importance of this item when considering the financial position. How far the accountant is responsible for finding items not on the books depends somewhat upon the particular circumstances and conditions in each case, but he is at least responsible for taking all reasonable steps and exercising due care and judgment in ascertaining such items.

As to the value of capital assets of a concern, custom and reason have to some degree limited the responsibility of the accountant, it being generally understood that he is not an appraiser. He is responsible, however, for showing clearly in the balance sheet the basis upon which assets are stated, that is, whether at cost or market values, etc.

There is some difference of opinion among practising accountants in regard to their responsibility for the quantities in physical inventories, some few holding the view that they should actually take the inventories. I believe that only in special cases should the accountant assume full responsibility for the quantities, on the ground that he cannot reasonably be expected to have an intimate knowledge of all the technicalities sometimes required to count and properly to classify goods on hand, particularly where they consist of a variety of product in varying stages of manufacture.

Persons devoting their entire time to any particular business or branch of business are better qualified to take the inventories correctly. While the accountant might be able to count and list goods on hand as rapidly as the employees of a concern, the identification of varying grades and classes of goods leading up to the pricing and valuing must be accurate, and in this respect the accountant is not as well qualified as others, and therefore should not, ordinarily, presume to be nor assume the responsi-

bility. Of course he must take all reasonable and practicable steps to satisfy himself that the inventory has been carefully and honestly taken and thoroughly verify prices, extensions and footings.

The question arises as to the accountant's responsibility in assuming to do that for which he is not specially qualified. To the ambitious and progressive accountant, generally well qualified and with confidence in himself, there is some temptation to undertake whatever his clients request, and it is when asked to perform such service, for which he is not qualified, that he is responsible for the course pursued. The seriousness of deciding wisely and fairly both to the client and himself can readily be appreciated, for it requires no stretch of imagination to understand that if the accountant is asked to plan and lay out the machinery in a manufacturing plant he cannot be as well qualified to perform such service as the mill engineer or superintendent; and should he comply with the request of his client and attempt such work he is assuming and is responsible for something for which he is not qualified. The old axiom, "that which is worth doing is worth doing well" applies in this case and it is my belief that in the comparatively short period of man's life if he is able to fit himself properly as an accountant and follows the profession there is not sufficient time for him also to become a trained engineer as well.

During the last few years the efficiency engineer has come into public notice and in some instances accountants have undertaken this work in conjunction with the accounting practice, but to my mind there is serious doubt of the wisdom of this course. The two professions are closely allied and the dividing line is difficult to establish. "When in doubt pursue the sure course." This principle applied in this case would result in the accountant's confining his efforts to those services for which he is specially fitted.

Generally speaking, all individuals are responsible for what they utter or write, but the accountant may be said to be in a peculiar position as regards this because he is in possession of a vast amount of information and facts concerning other people's affairs, more particularly those of a confidential and personal character, and if this is intentionally or unintentionally, directly or indirectly, improperly disclosed the result is in many cases

## *Qualifications and Responsibilities of Accountants*

much more harmful to others than to himself. It may only require the misspoken word or thoughtless action to bring about serious results.

I have in mind a personal experience which will illustrate this point. In an audit of a bank I was seen entering the building after banking hours by one of the depositors who, knowing that I was an accountant, imagined that something was wrong with the bank and hastened to inquire of another depositor if this was true. Fortunately the man who saw me entering the bank inquired of me the following morning as to the situation, when I was able to relieve him of his anxiety as to the financial position of the bank and advise him that our audit was only the usual verification. It will be seen that I narrowly escaped quite innocently starting a run on the bank, and while I would have been entirely blameless it might have been said that in a sense I was responsible therefor.

We are continually reminded in various ways of our responsibility, but we are brought face to face with it in a special way when signing our certificates to financial accounts which are distributed to stockholders and investors. The seriousness is unmistakably impressed upon us when signing our names to statements upon which may rest such far-reaching good or ill and will redound either to the signer's credit or discredit.

That accountants realize their responsibility in this respect is shown by the improvement in the form of the usual auditor's certificate and financial statement, more especially in the wording used. It would appear, however, that the general business public does not give due consideration many times to what is said in the accountant's certificate and the explanations that are made in the captions of the financial accounts. Too often if the accountant's signature is seen on the certificate to a balance sheet the public assumes that everything is in order without taking the precaution to read the certificate or the explanations.

To sum up the accountant's responsibility in general terms, I should like to quote what has been said by A. Lowes Dickinson:

But the public accountant has only one duty to his client and to the public, and that is to disclose to him or for him the truth. . . . so far as his abilities or special training enable him to ascertain it. No legal quibble will save him from moral condemnation if he fails in his duty. No juggling with words or phrases will absolve him from responsibility,

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moral and often legal, for results which he has reason to know are not what they seem to be or which, having regard to his special training in public affairs and accounts relating thereto, he ought to have known did not represent the facts. Errors there may be and must be, and for errors made after full and proper precautions are taken and due care exercised no responsibility will lie. But there is no profession in which the results of careless errors or misstatements more certainly bring retribution.

### QUALIFICATIONS

Having given at least some idea of the responsibility of the public accountant, it seems obvious that one must have special training and attainments in order to fulfil the obligations assumed with satisfaction to his clients, the public and himself. Generally speaking, the qualifications may be divided into three classes: personal qualities, education, practical experience. Taking up these qualifications in the order named—which, however, should not be considered the order of their relative importance, but rather the logical arrangement—it is evident that of the first, personal qualities, some are inherent rather than acquired.

In the first place no person should undertake the work who has not in the beginning a sterling character, the highest regard for honesty, a quickened conscience and a special liking for the work. That all the other virtues are desirable goes without saying, but without those specified it seems a betrayal of the confidence of others to hold oneself out as practising a profession which involves the absolute confidence of clients in unfolding private and personal matters.

There are some other qualities which are highly desirable although perhaps not absolutely necessary, such as a pleasing personality, a tactful and gracious manner and unselfish disposition—particularly the latter, as the accounting profession is not different from the other professions in that the reward cannot be measured entirely by material standards.

The educational qualifications may be said to be more or less elastic. It is a fact that some of the ablest and most successful practising accountants are not college men, but this is doubtless due largely to the fact that when these men were preparing for the profession educational opportunities were not as good as they are to-day and there were many more difficulties in the way of taking advantage of those that were offered. But I venture to say that few practising accountants who have not had a college

### *Qualifications and Responsibilities of Accountants*

education do not consider it their misfortune. The accountant should have a college education if possible, and at least the equivalent of a high school education supplemented by special studies in mathematics, economics, English, political economy and commercial law. The primary value of education along these lines is not so much for the book knowledge obtained, much of which is usually forgotten, but for the mental training and development of the faculties.

One of the particular faculties highly necessary to the accountant is the ability to concentrate the mind upon the problems to be met and solved. The analytical mind is in a special manner required in order to separate the essential facts and information from those of less importance surrounding the many and varied questions. Imagination and ingenuity as well as originality are often brought into play. Because each case and each problem differs in some respect, the reasoning faculty is continually required in arriving at wise and just conclusions, and the faculty of being able to adapt oneself to conditions both of work and of life makes the pursuit of the profession easier and more enjoyable.

The accountant must possess all these qualities, obtained either through the medium of schools and colleges or through the more or less general school of life in order that he may advise clients wisely and guide them safely in business and accounting matters.

In comparatively recent years vocational training has received careful consideration by educators and business people and has been adopted by many educational institutions. The tendency to specialize in particular branches of the professions and other vocations has increased in recent years and with this tendency have come added opportunities for education. The schools equipped for special education and particularly applicable to the accounting profession have been and still are limited in this country, although during the last ten years much progress has been made and many of our colleges and schools now have departments and courses on accounting and business subjects, so that there are opportunities for elementary training and special study in preparation for accounting work.

But the educational qualification is only one step in the preparation of the accountant and must be followed or supplemented



by practical experience. As the lawyer is looked to, primarily, for advice and counsel in matters involving the law, and the doctor for relief from bodily ills, so the accountant is being sought out to a rapidly increasing extent for advice and guidance in business affairs. As these demands may come from those engaged in all kinds of business undertakings, from the great industries to the smallest enterprises, from government officials, charitable and benevolent institutions, etc., obviously, the accountant, to be able to render such service, must have experience coupled with the other qualifications already mentioned.

It does not necessarily follow that he must have been a captain of industry or have worked at the bench in a manufacturing plant, but it does mean that he must have a broad and working knowledge of all kinds of business, obtained not only from books but from observation. He must learn to apply in a practical manner the theory obtained, and the only way to qualify in this respect is by going through the school of experience.

The best way to obtain the necessary experience is in working as an assistant with and for practising accountants. This affords an opportunity of first seeing the work done and actually performing certain of the details, and through this means gradually acquiring the store of knowledge and experience desired.

Accountants have been instrumental in fixing standards and qualifications, as prerequisite for the degree of C.P.A. which is issued under state laws. There are now forty states with laws of this kind upon the statute books. In this way the public is protected to some extent in that the states assume the responsibility of ascertaining that those who hold themselves out as qualified to practise accountancy have at least the prescribed minimum qualifications.

In what I have said my aim has been to put forward what I conceive as the responsibilities of the public accountant and the qualifications he should have. It is unfortunately true that all practitioners do not come up to the standards indicated, but our ideals must be high and those who would make the profession their life work should fully appreciate that their success, reputation and livelihood depend upon their realization of the responsibilities of the work.

## Credit Conditions in South American Countries\*

BY JAMES MATTHEWS

Undoubtedly the most important problem connected with South American trade is credit. The general criticism made against the policy of the American exporter by the South American buyer is concerning the question of credit. The necessity for credit in South America is a vital one. British and German exporters discovered this upon entering the South American markets many years ago, and they have catered to this requirement to the apparent satisfaction of the merchants there.

While it has been the custom of many of our manufacturers to grant credit to houses of unquestioned standing in South America, the practice of demanding cash against surrender of documents in New York has been followed by a number of manufacturers because they have found that they were not properly equipped to handle this class of business. The business man in this country who has been willing to grant credit to his home trade anywhere from three to six months hesitates to do so when it comes to shipping his goods to foreign countries. With the modern means of communication and transportation throughout this country, he is accustomed to doing business with the quickest despatch, and it is difficult to adapt himself to the conditions surrounding business in South American countries. The lack of proper banking facilities, absence of quick mail communication, difficulty of obtaining credit information and possibility of not receiving sufficient warning of any change in the financial position of a house, fear of unfounded complaints, unwarranted deductions, unreasonable delays in shipments and difficulties in liquidation are questions which enter seriously into his consideration in conducting a foreign business.

The policy of demanding cash against documents at seaboard is at direct variance with the terms afforded by European exporters, who are always willing to deliver goods to buyers on

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\*An address delivered before the New York State Society of Certified Public Accountants, October, 1916.

terms ranging from four to six months, and sometimes longer. Bankers naturally regard with disfavor the lengthening of time beyond three months, but the custom of long credits, particularly in the metropolitan sections of South America, is gradually disappearing. South American merchants of sound business judgment realize the fallacy of the practice. They are showing an eagerness to resort to shorter terms, and to make the limit six months, although ninety-day terms would be more favorably regarded.

Although there are certain features of the South American credit situation, due to general financial conditions and methods used in the merchandising of goods, that cause differences between localities in the technicalities of credit risks, the moral element in credit is very nearly the same all over Latin America, and the standard of business honor is very high or none at all. Reputation is everything to the average Latin American business man. He who shows moral delinquency in trade is usually ostracized. Family ties are strongly binding, and if a merchant fails honorably he is often helped to solvency by his relatives, who will usually go a long way in assisting him rather than have the family name tarnished in any manner. It is the opinion of many who have had long and intimate relations with South America that the merchants there have just as high a sense of business honor as the merchants of any other country in the world.

Notwithstanding the large export business which many of our manufacturers have built up with Latin American countries, they have labored under great disadvantages compared with their foreign competitors in regard to banking facilities and the means of securing satisfactory credit information.

Important financial interests of England and Germany maintain large banking institutions in South America. There are also local banks owned by South Americans. These foreign banks were brought into existence in the interest of foreign trade, and their principal object is the promotion of the commerce of their particular nationality. They are of valuable assistance in furnishing definite information as to the standing of merchants in South America. They are constantly in touch with all that is going on and can advise their clients at home of the desirability of extend-

### *Credit Conditions in South America*

ing credits to South American merchants or of any changes which may take place from time to time in the affairs of those merchants. As there is keen rivalry between these banks, there is naturally little co-operation of any kind, and they do not exchange credit information with each other.

It is naturally to banks that exporters look for information on concerns in foreign countries, and in considering South American credit conditions, the lack of co-operation between banks and the natural tendency to over-extension of credits must not be overlooked. In this country banks, generally speaking, are willing to exchange credit information and the credit-man is usually able to secure definite knowledge of the exact lines of accommodation which a borrower obtains from his bankers.

One of the leading mercantile agencies in this country has several branches in South America, and has acquired a great deal of valuable information which is available to American exporters. There are also local mercantile agencies, which conduct their business along somewhat similar lines. The business men of this country, however, have become accustomed to obtaining opinions of bankers on important credit risks, and most banks throughout the United States augment in an efficient manner the information furnished by the mercantile agencies. Therefore, through means of their own and the aid of other banks, they, as the result of a broad spirit of co-operation, are in a position to furnish American business men with close and accurate information upon the responsibility and standing of merchants and manufacturers all over this country.

The enactment of the federal reserve law, permitting national banks to establish branches in foreign countries, will be of valuable assistance to our exporters, and enable them to cope with foreign competition more successfully than heretofore. The most important service which can be performed by these branch banks, aside from the development of an active banking business with foreign countries, will be the building up of a system of accurate credit information to be made available to the commercial interests of this country.

To meet the necessities of American exporters, the National City bank of New York has established branches at Buenos Aires, Montevideo, Rio de Janeiro, Sao Paulo, Santos, Bahia,

Valparaiso, Havana and Santiago, which it will increase as conditions will warrant, and is also opening branches in Italy and Russia.

The collection of credit information in South America is in reality a diplomatic task. In Latin American countries, merchants are not accustomed to the system of exchanging credit information which is in vogue in this country, and is, in fact, peculiar to the United States, as nowhere in the world do we find sources of trustworthy information so easily available as we do in our own country. Even in Europe much reserve surrounds the banker and business man in imparting information appertaining to the standing and responsibility of their customers or competitors, and the South American clings closer to the customs of European countries than he does to those of the United States. The business education of South Americans has been given in Europe, and the business atmosphere of South America has a distinct European calmness.

On account of the attitude of foreign banks toward each other, we cannot expect that they will be liberal in giving information to American banks, although it is only fair to say that experience with many of them so far has been far from disappointing, considering all the circumstances. While these banks are not willing to enter into extended details about a man's affairs, they often give information which is a material aid in intelligently extending credit. As they have gathered most of their information from experience, they feel that others should gather theirs in the same way. Probably they had no statements of merchants with which to be guided in extending credit when they began business, and what they know about them, no doubt, is the result of several years of close business contact with them. Now, although some banks will tell you that they deem a concern to be good for a certain amount of credit, they will not always tell you, as banks do here, what line of credit they might be giving them, or whether or not they would give them more. In practically all instances, however, they do not hesitate to tell you if they do not consider a man worthy of credit, which, after all, perhaps, is the most important question in the extension of credit. In other instances there is sometimes present a desire to give an evasive reply where it suits the judgment of bankers to do so,

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especially where it is a case of getting a man to pay up his indebtedness and going out of debt with them. So far as local or native banks are concerned, however, there is a disposition to give information more freely, and on the whole it is quite trustworthy. These banks frequently supply important details and are usually frank in expressing their judgment of a credit risk.

South American merchants are not accustomed to furnishing statements as readily as merchants in this country. While some see the advisability of making statements when the matter is properly explained to them, it is not uncommon when requesting a statement from a merchant to be met with an answer to the effect that he has always been able to secure all the credit he needed without giving a statement, and, therefore, can see no reason for giving one now. This position is not always taken because the merchants fear that if their condition were to become known it would not be regarded by the banker as satisfactory, but it is frequently taken through fear of their condition becoming known to those who are not entitled to the information. Gossip is a remarkable thing in those countries, and merchants are fearful that their competitors might secure information as to their business and use it to their detriment. However, they are gradually realizing that in furnishing financial statements they are placing themselves in a position which will warrant the full confidence of bankers and merchants from whom they desire credit.

A record of detailed statements secured by South American branches from houses to which accommodation has been extended shows that nearly 50 per cent. have complied with this practice; while information has been obtained direct and from others well informed about the financial affairs of the remainder to enable one to get a very fair idea of where they stand financially.

The practice of employing certified public accountants to audit their affairs does not appear to have made any headway among South American merchants. Houses owned by residents of England and branches of English houses sometimes employ public accountants to make annual audits; but, for some reason or other, the South American has not been brought to see the advantage that an audited statement would be to him personally and to his bankers. It is hoped, however, that the day is not far

distant when the system of public audits will be commonly adopted. There is no doubt that it is of incalculable benefit to bankers in acquiring a proper knowledge of a borrower's financial stability on which to base the extension of credit. Bankers in this country, notwithstanding the full confidence which they have in the high character and ability of the borrower, place more reliance, as a rule, upon a statement audited by certified public accountants than one which is drawn up by a borrower's own accountants. Such an audit is not likely to reflect the natural optimism which might exist in the mind of a borrower toward his own affairs.

In extending bank credit to South American concerns, one naturally has to rely upon his own judgment. While banks there, as a rule, are very free in extending credit, there is considerable variance in the amount of credit which different banks will grant the same customer. Because of the lack of co-operation among South American banks, it is not at all unusual for a man entitled to a total banking credit of only \$50,000 to receive that amount from three or four banks at the same time. This has led to an inflation or over-extension of credit and has made difficult the question of extending credit to many houses there.

The paper which banks carry as collateral for loans is subject to practically no governmental supervision in South America, and there is no official system by which loans among banks can be checked up. While it seems to many of us in this country that foreign banks sometimes assume hazardous risks, the success which the more important institutions have experienced throughout a long period shows that they have managed their business wisely and with great skill.

The nominal practice of banks is to discount 90 day paper, but custom has caused renewals to become popular and frequent, and loans actually run for a much longer time. The system of loans in vogue among South American banks is on account current or overdrafts, single name notes, endorsed or guaranteed notes, acceptances, bills receivable, warehouse receipts and securities in the form of stocks, bonds, government and municipal notes. The account current or overdraft system, however, is the most common practice in all Latin American countries. This method follows the practice among European banks. It is very convenient to the borrower, as it saves him interest which he

### *Credit Conditions in South America*

would otherwise have to pay on borrowed money awaiting his call, but for which he may have no immediate use. It is an unsecured advance and is equivalent in character to borrowing on a single name note, and the bank is usually covered for the advance by a document prepared for this specific purpose.

There is sometimes a tendency among merchants in South America to do a larger business than their capital warrants, but we find that many of them are careful to whom they sell and watch collections with exceptional closeness. The losses which they incur through bad debts are in many instances very small, although in certain outlying communities, because of fluctuating conditions, the losses sustained are sometimes large.

It is advisable to avoid legal proceedings in South America as far as possible, because as a rule they are expensive and unsatisfactory. While there are bankruptcy laws in those countries, there are no laws by which to apprehend or convict dishonest debtors. There are no laws there which restrict the sale of goods in bulk and there is no way by which to prevent the dishonest debtor from disposing of his stock as he sees fit unless his creditors learn of his intentions and secure control of his stock beforehand. Neither are there laws in those countries which make it a criminal offense to issue a false statement. But many of us can attest to the utter inability, until recently, of creditors in this country to punish debtors who obtained credit by the use of false statements; and even yet it is only in a few states that legislation has been effected making it a criminal offense to issue a false statement for the purpose of obtaining credit. While many of our states have succeeded in placing a bulk sales law on their statutes, there are several states which are still without such a law. Those in this country who have been guilty of issuing false statements have not been wholly confined to a class whose moral sensibilities might reasonably be regarded with suspicion, but have included men who have occupied the highest places of honor in our financial, commercial and public life, and naturally have held the respect of the community at large. We should not lose sight of this fact, therefore, when measuring the moral stamina of business men in South America. There are business men in all countries who have for a time held



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the confidence and respect of their community, but have eventually been found to be dishonest. Investigation shows they do not exist in any greater proportion in South America than in other countries.

While there are several difficult problems before us in doing business with South America, and the most important of these is the question of credit, yet, if we are to build up our business there, these problems must be seriously studied. They are not more difficult than the problems we have had to solve in this country, and if we will take them up and study them comprehensively, we can succeed in overcoming them as we have done those of our own.

# The Journal of Accountancy

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A. P. RICHARDSON,

Editor

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## EDITORIAL

### The Board of Examiners

Since the formation of the Institute of Accountants in the United States of America it has been recognized by everyone who has taken an intelligent interest in the work of the institute that the utmost importance attaches to the board of examiners and the conduct of examinations under that board.

It was felt by the council that the members of the board must be men who had absolutely no direct connection with any school of accountancy. This, of course, meant the elimination of many men who would have been admirable members of the board of examiners, but the fear that the preparation of students for examinations might be in the hands of the same men who would conduct examinations rendered it imperative to avoid such a possibility.

The board which was elected by the council on September 20th lost no time in organizing and undertaking the initial work which devolved upon it.

Rules and regulations have been adopted governing the general examination of applicants and special rules have been approved for the examination of applicants in June, 1917. These special rules have reference chiefly to the oral examination of applicants.

Under the by-laws of the Institute of Accountants the examinations may be conducted annually or semi-annually and the board has considered it wise to set aside the first half of December and June of each year for holding examinations. Under this decision it was impracticable to conduct examinations in December, 1916, as the applications would not be in the hands of the secretary of the board sixty days in advance of the examination

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if it were held at that time. Accordingly, the first examination will be held some time in the first fifteen days of June next, and we are informed that a great many applicants will appear at that time for oral or written examination.

The examinations to be held will constitute the first national examination of accountants in this country. Almost innumerable examinations have been conducted by state boards in the states in which certified public accountant laws exist; but certificates issued as the result of such examinations have been of local effect chiefly and did not carry with them anything in the nature of a national and interstate endorsement. Those who pass the examinations to be set by the Institute of Accountants, on the other hand, will have back of them the approval of a truly national organization. This in itself will add greatly to the prestige of the accountants themselves, and under the disciplinary provisions of the by-laws it appears that the public and the honor of the profession will be safeguarded whenever unprofessional conduct or other offense is proven against any member or associate of the institute.

In view of the great importance which attaches to the rules and regulations of the board, we publish herewith the general rules which have been adopted and will apply to all examinations until a change becomes necessary:

### **RULES AND REGULATIONS OF THE BOARD OF EXAMINERS OF THE INSTITUTE OF ACCOUNTANTS IN THE UNITED STATES OF AMERICA**

Adopted November 15, 1916

#### **OFFICERS**

The officers of the board shall be a chairman, a secretary and a treasurer.

#### **MEETINGS**

The annual meeting of the board shall be held at the place of the annual meeting of the institute on the day following the adjournment of that meeting. Special meetings may be held upon the call of the chairman and shall be called by the chairman upon the written request of three members. Ten days' notice of all meetings shall be given by the secretary. Five members of the board shall constitute a quorum.

#### **SECRETARY**

The secretary of the institute shall be the secretary of the board. The secretary shall keep a record of all applications received and also the records of the meetings and transactions of the board. He shall turn over to the treasurer of the board all moneys received by him.

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### TREASURER

The treasurer of the institute shall be the treasurer of the board. All moneys received by the board shall be turned over to the treasurer. Disbursements shall not be made by the treasurer except upon the approval of three members of the board.

### OFFICE

The office of the institute shall be the office of the board.

### APPLICATION AND FEE

Applications will be considered only when made on blanks which will be furnished by the secretary on written request. The fee for examination shall be \$25.00, must accompany the application and shall not be returnable unless the application be withdrawn before consideration by the board. The fee for each re-examination shall be \$10.00.

No applicant shall be entitled to an examination by the board unless his application shall have been in the hands of the secretary of the board sixty days prior to the date of examination.

### EXAMINATIONS

Except as hereinafter provided, the examinations of the board shall be written, and every applicant for admission as a member or associate or for advancement to membership who shall be found to be qualified to take an examination under the constitution shall be entitled to take the written examination of the board and upon passing such examination to the satisfaction of the board shall be recommended to the council for admission or advancement, as the case may be.

No applicant shall be allowed to take an examination who shall not previously have satisfied the board as to his preliminary education. A high school graduation certificate will be regarded as satisfactory evidence of such preliminary education, but until further notice the board will consider such other evidence as may be submitted.

### EXAMINATIONS—WRITTEN

Examinations shall be conducted simultaneously in such places as may be determined by the board of examiners during the first fifteen days of June and December, the dates to be selected ninety days in advance of examination.

Due notice will be given to each applicant of the time and place selected for holding the examination. Failure to be present and prepared at the time appointed will be sufficient cause for exclusion from any session of the examination.

Examinations shall include questions in (1) accounting theory and practice, (2) auditing and (3) commercial law, and the time required shall not exceed two days.

Answers shall be written in ink in accordance with instructions which will be issued at the time of examination. All supplies necessary to the examination will be furnished by the board and, after use, shall remain the property of the board.

The secretary shall communicate in writing to each applicant the result of his examination in each subject, and the applicant shall not be entitled to further information.

Applicants who shall have passed the examination in two subjects only shall have the right to be re-examined in the third subject upon payment of the re-examination fee of \$10.00.

### EXAMINATIONS—ORAL

Applicants possessing such qualifications as the board may from time to time prescribe may in the discretion of the board and upon the request of the applicants, be subjected to oral instead of written examination in one or more subjects.

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An affirmative vote of five members of the board shall be required before any applicant who has taken an oral examination shall be recommended to the council for election or for advancement to membership.

Special rules applicable to the June, 1917, examinations provide that applications for oral examination will be considered from accountants who have been in practice since September 1, 1911, to the date of their application, and from associates of the institute who have been in practice the same length of time either on their own account or in the employ of members of the institute.

Applications for oral examination from persons desiring to become associates will be considered if the board is satisfied that such applicants were prevented from becoming members of the American Association of Public Accountants prior to September 19, 1916, by conditions beyond their control and if they shall complete prior to March 1, 1917, the qualifications which would have entitled them to such membership. In the case of the last named class of applicants it is understood that the fee for examination will be merely nominal.

The board will not consider other applications for oral examination at the June, 1917, session except from persons who at the date of their application shall have been seven years in practice on their own account or in the employ of a practising public accountant.

The board reserves to itself the right to reject any application for oral examination.

Application forms of a comprehensive nature have been prepared by the board and are available to those who desire to become members or associates.

Probably the most noteworthy feature of the application form is the certificate, which must take the form of an affidavit before a notary public:

"I hereby certify that the statements above are correct to the best of my knowledge and belief; and I further certify that I have never been convicted by any court or other body of any crime, misdemeanor or discreditable act; that I have never been suspended or expelled from any professional organization, and that I have not suppressed any information which might have a bearing upon this application.

*Editorial*

## Warning!

Numerous complaints have been received by THE JOURNAL OF ACCOUNTANCY from persons who have been misled by a man known as Frank Osborne, Frank Monroe, Frank Williams and other names, representing himself as an agent of the American Association of Public Accountants, of THE JOURNAL OF ACCOUNTANCY or of the Institute of Accountants.

His operations have carried him through a large part of Ohio, Indiana and West Virginia and his victims have been many. His plan is to promise four or five accounting books as a bonus to subscribers.

THE JOURNAL OF ACCOUNTANCY regrets that so many people have been imposed upon by this man, but it seems almost unnecessary to point out that no canvassers are ever employed by the Institute of Accountants or the American Association of Public Accountants or THE JOURNAL OF ACCOUNTANCY.

Any reader who may hear of a man canvassing for subscriptions to THE JOURNAL OF ACCOUNTANCY will do well to inform the nearest police authorities and advise the office of this magazine promptly.

# Income Tax Department

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

In the act of September 8, 1916, congress imposed certain other taxes, in addition to renewing and increasing the taxes on the net income of individuals and corporations which were in force at that time. The income tax department of THE JOURNAL OF ACCOUNTANCY was instituted in 1913 when the federal income tax law was originally enacted by congress because it was thought that not only would accountants be asked in many cases to prepare the reports upon which the tax is based, but that as a natural sequence of the law they would also be asked to modify the form of the records and accounts of many concerns so that the information necessary to make up the reports would be available with the least trouble possible. In these circumstances therefore it was considered essential at that time that accountants should have some means of knowing the terms of all rulings and regulations issued by the treasury department and of all decisions of court affecting the administration of the provisions of the law. Two of the new taxes imposed by the act of September 8, 1916, are upon corporations, or certain classes of corporations, the tax in one case—munition manufacturers' tax—being based on net income, and in the other case—special tax on corporations—being based on capital stock; and it is felt that the considerations which prompted the starting of this department in 1913 as a service to the profession in respect of the income tax also impel the inclusion of some details at least of the two new taxes just referred to in these pages so that all information of importance in respect of the imposts by the federal government on corporations may be presented to readers. In this month's JOURNAL, therefore, the matter has been separated into three divisions and reference will be made to them in the order in which they appear.

## I. INCOME TAX

The special regulations under the act of September 8, 1916, which were promised some time ago, have not yet been promulgated, and such rulings as have been issued are of minor importance. They are:

T. D. 2382 which deals with the collection of income tax on dividends received on stock of domestic corporations or resident alien corporations which is owned by a non-resident alien individual or non-resident alien corporation. The law now requires that income tax be paid on all dividends received on stock owned by a non-resident alien corporation, or a non-resident alien individual and the tax is to be withheld at the source by the debtor corporation. The operation of this provision will be simple where the actual owner is the stockholder of record; but in many instances this is not the case, and instead an agent either in this country or abroad is entered as the stockholder of record to whom the dividends

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are paid and who is the only party having an interest in the stock so far as the corporation is concerned. The liability for tax is placed on the stockholder of record and he is required to include it in his own personal return; but, if the stockholder of record is only the nominal owner, he will be relieved from the personal liability if he files with the debtor corporation a certificate (form 1087) disclosing the identity of the ownership of the stock. If, however, the agent is a citizen or resident alien he is liable for the tax payable by his principal as the agent of that principal.

T. D. 2386 also deals with dividends on stock owned by non-resident aliens and, in the case cited, the non-resident alien is permitted to appoint an agent in this country and on this being done, and the fact published, the tax will not be deducted at the source but will be paid on the return filed by the agent in the United States.

### II. MUNITIONS MANUFACTURERS' TAX

The text of the law imposing the munitions manufacturers' tax has been issued by the treasury department as T. D. 2362 and regulations have been issued as T. D. 2384, to which reference is made for full details. In brief, a tax of 12½% is levied on the net income of the corporation from the manufacture of munitions.

### III. SPECIAL EXCISE TAX ON CORPORATIONS

The text of the law and regulations providing for the special excise tax on corporations appear together in T. D. 2383, which is also printed herewith. This tax is one of 50c. per \$1,000 par value of capital stock in excess of \$99,000.

#### I. TREASURY RULINGS ON INCOME TAX.

(T. D. 2382, October 19, 1916.)

Providing certificate to disclose identity of ownership of stock where the stock is registered in a name other than that of the actual owner.

Dividends on stock of domestic corporations or resident alien corporations are held to be income to the record owner of the stock, and such record owner will be liable for income tax, normal or additional, according to his or its individual or corporate status, unless a proper certificate showing that actual ownership rests with another is filed.

When stock in a domestic or resident alien corporation whose net income is subject to the normal income tax is issued in the name of another than a nonresident alien corporation, the dividends on such stock will not be subject to the withholding of normal tax under the provisions of section 13 (f) of the act of September 8, 1916, except when the debtor corporation, or its withholding agent, has knowledge that the actual owner of the stock is a nonresident alien corporation subject to withholding.

When stock in a domestic or resident alien corporation is actually owned by a nonresident alien individual or nonresident alien corporation, and the stockholder of record is an individual, firm or corporation acting as agent for the actual owner, such agent by executing and filing with



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the debtor corporation the certificate herein provided may secure relief from accounting for the dividends on such stock as his or its personal income, but where the agent is a citizen of, or resident in, the United States, he or it will be required to make return and pay tax for the non-resident alien individual owner when the amount of dividends received is sufficient to call for the additional tax provided by section 1 (b) of the act of September 8, 1916, and in all cases for the nonresident alien corporation for the purpose of the normal tax.

The debtor corporation will be governed as to withholding by the facts as to actual ownership disclosed by said certificates. All certificates filed with debtor corporations for the purpose of disclosing agency and the actual ownership of stock in domestic or resident corporations shall be forwarded by the debtor corporation, or its withholding agent, to the collector of internal revenue for its district, on or before the 20th day of the month next succeeding the month during which said certificates were received.

The term "corporations" as used above covers corporations, joint-stock companies or associations, and insurance companies. The term "nonresident alien corporations" covers all corporations, joint-stock companies or associations, and insurance companies organized, authorized, or existing under the laws of a foreign country and having no office or place of business in the United States; the term "resident alien corporations" such foreign organizations as have such an office or place of business.

The certificate shall be in the following form:

Form 1087.	<b>OWNERSHIP CERTIFICATE—DISCLOSING ACTUAL OWNER OF STOCK.</b>								
	(For use of registered owner—individual, firm or organization, resident or nonresident alien—to disclose actual ownership of stock, when registered owner is not the actual owner and actual owner is a nonresident alien individual or a nonresident alien firm or organization.)								
TREASURY DEPARTMENT, INTERNAL REVENUE—INCOME TAX.	<table border="0" style="width: 100%;"> <tr> <td style="width: 50%; border-top: 1px dotted black; padding-top: 5px;">                             (Name of actual owner.)                         </td> <td style="width: 50%; border-top: 1px dotted black; padding-top: 5px;">                             (Full post-office address of actual owner.)                         </td> </tr> <tr> <td style="border-top: 1px dotted black; padding-top: 5px;">                             (Name of issuing corporation.)                         </td> <td style="border-top: 1px dotted black; padding-top: 5px;">                             (Address of issuing corporation.)                         </td> </tr> </table>	(Name of actual owner.)	(Full post-office address of actual owner.)	(Name of issuing corporation.)	(Address of issuing corporation.)				
(Name of actual owner.)	(Full post-office address of actual owner.)								
(Name of issuing corporation.)	(Address of issuing corporation.)								
	Number shares stock owned..... Par value \$..... Amount of dividend.....								
	I (we), the record owner of the above-described stock, hereby declare that the actual owner of said stock is correctly named and listed above; that said actual owner is a nonresident alien as to the United States; and that all the information given herein is true and correct.								
	Date,....., 19								
	<table border="0" style="width: 100%;"> <tr> <td style="width: 80%; border-top: 1px dotted black; padding-top: 5px;">                             (Signature of registered owner, or, if organization, name.)                         </td> <td style="width: 20%;"></td> </tr> <tr> <td style="border-top: 1px dotted black; padding-top: 5px;">                             By.....                         </td> <td></td> </tr> <tr> <td style="padding-top: 5px;">                             (If organization, signature of official authorized to sign and official position.)                         </td> <td></td> </tr> <tr> <td style="border-top: 1px dotted black; padding-top: 5px;">                             (Full post-office address of registered owner.)                         </td> <td></td> </tr> </table>	(Signature of registered owner, or, if organization, name.)		By.....		(If organization, signature of official authorized to sign and official position.)		(Full post-office address of registered owner.)	
(Signature of registered owner, or, if organization, name.)									
By.....									
(If organization, signature of official authorized to sign and official position.)									
(Full post-office address of registered owner.)									

## *Income Tax Department*

Said certificate shall be printed on buff-colored paper corresponding in weight and texture to white writing paper 21 by 32, about 40 pounds to the ream of 500 sheets. The size of said certificate shall be 8 by 3½ inches, and shall be printed to read from left to right along the 8-inch dimension.

Individuals or organizations desiring to print their own certificates may do so, but certificates so printed must conform in size and be printed in similar type and upon the same color, shade and weight of paper as used by the government.

(T. D. 2386, October 19, 1916.)

Dutch Administration Offices as the registered, but not the actual, owners of stock of domestic or other resident corporations in the United States to disclose the identity of the actual owners of said stock for the purposes of the withholding provisions of section 13 (f), act of September 8, 1916.

Dutch Administration Offices being nonresident alien corporations not engaged in business or trade in the United States, and not having an office or place of business therein, and said Dutch Administration Offices being the registered owners of stock of domestic or other resident corporations in the United States, are prima facie liable for the normal income tax on income derived from dividends upon the capital stock or from the net earnings of the aforesaid domestic or other resident corporations in the United States and to having the tax deducted and withheld from such income under section 13 (f), act of September 8, 1916.

It appearing that the Dutch Administration Offices, while the registered owners of stock as aforesaid, are not the actual owners thereof, but that they have issued their bearer certificates, with coupons attached, against said stock, and that the dividends on said stock are collected for the account of the holders of said bearer certificates and that the relation sustained by said Dutch Administration Offices to the said bearer certificate holders is that of agent, for the purposes of administration the Dutch Administration Offices may appoint an agent in the United States and give notice of that fact by filing in duplicate with each corporation issuing the stock so held by said Dutch Administration Offices, a notice in substantially the following form:

You are hereby advised that.....  
(Name and address of Dutch Administration Office)  
the registered owner of stock in....., has appointed  
(Issuing corporation)  
....., whose address is .....,  
(Name of agent)  
as its agent in the United States.

Upon receipt of notice as aforesaid, debtor or issuing corporations in the United States may pay over to said Dutch Administration Offices or their agent in the United States all dividends, without withholding any tax, and shall forward to the commissioner of internal revenue one copy of the said notice of the appointment of the agent in the United States.

It will be necessary to file this notice but once, unless there shall be a change of agent, when a similar notification should be given.

When it shall appear that the Dutch Administration Offices have an agent in the United States and when, because of that showing, dividends of domestic or other resident corporations in the United States shall have been paid to them without withholding of tax, said Dutch Administration Offices, through their agent in the United States, will be required to make returns of income and pay tax on all dividends received except such as shall be shown to have been received by them for the account of nonresident alien individuals. This showing shall be made by way of certificate No. 1087, prescribed by T. D. 2382, and all such certificates shall be at-

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tached to the return when filed. The form of return for reporting tax withheld from dividends will be prescribed by the commissioner of internal revenue.

Where the normal tax has heretofore been withheld from Dutch Administration Offices which, under the foregoing, would not have been withheld if they had had an agent in the United States, they may, through an agent to be appointed by them in the United States, file with the commissioner of internal revenue at Washington a statement in which shall be set out—

(a) The name and address of the Dutch Administration Office which is the registered owner of stock of domestic corporation, and the fact that it is the registered but is not the actual owner of such stock.

(b) The name and address of each corporation in which stock is so held; the amount of dividend paid by each corporation; the amount of tax withheld by each corporation.

(c) The names and addresses of the actual owners of the stock; the amount of stock owned by each; amount of dividend payable to each. The showing called for in this paragraph (c) shall be made by attaching to the statement certificates, form 107, prescribed by T. D. 2382.

When it shall appear by such statement and showing that tax has been withheld in excess of liability of the Dutch Administration Offices for tax, this office will give the necessary instructions to the withholding agent to release and pay over the amount of tax withheld in excess.

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(T. D. 2388, October 30, 1916.)

Adapting income tax form 1012 for use by debtor corporations in reporting income tax withheld from dividends paid to nonresident alien corporations, etc.

The duty of withholding income tax from dividends under section 13 (f), act of September 8, 1916, rests upon domestic or other resident corporations paying the dividends. When it shall be made to appear, as provided in T. D. 2382 or otherwise, that the actual owner of its stock is a nonresident alien corporation, etc., it shall be the duty of the debtor or issuing corporation in the United States to withhold 1 per cent. from September 9 to December 31, 1916, inclusive, and 2 per cent. thereafter, as income tax, from the amount of dividend it pays to each nonresident alien corporation, etc., and shall make return of such withholding on monthly returns provided for the purpose.

Until such returns are printed and distributed, debtor or issuing corporations will use income tax form 1012 and stamp across the printed declaration at the top of the form, in large letters, "Monthly return of income tax withheld from dividends paid to nonresident alien corporations," etc.

The name and address of the withholding agent and of the debtor corporation will be inserted in the blanks provided for that purpose. As there is no exemption which may be claimed by nonresident alien corporations in receipt of dividends from domestic or other corporations resident in the United States, the column "Amount of exemption claimed" and column "Amount of income on which withholding agent is liable for tax" will be disregarded. The amount of dividend payment in each case will be entered in the column "Amount of income," and the amount withheld will be entered in the last column.

Such return will be accepted by this office as a compliance with the requirement for monthly return of income tax withheld from dividends paid to nonresident alien corporations pending the printing and distribution of form specially provided for that purpose.

## Income Tax Department

### II. TREASURY RULINGS ON MUNITIONS MANUFACTURERS' TAX.

(T. D. 2362, September 11, 1916.)

*Munitions manufacturers' tax—Act of September 8, 1916.*

The appended extract from act of congress, approved September 8, 1916, is published for the information of internal revenue officers and others concerned.

#### TITLE III—MUNITION MANUFACTURERS' TAX

SEC. 300. That when used in this title—

The term "person" includes partnerships, corporations, and associations;

The term "taxable year" means the twelve months ending December thirty-first. The first taxable year shall be the twelve months ending December thirty-first, nineteen hundred and sixteen; and

The term "United States" means only the states, the territories of Alaska and Hawaii and the District of Columbia.

SEC. 301. (1) That every person manufacturing (a) gunpowder and other explosives, excepting blasting powder and dynamite used for industrial purposes; (b) cartridges, loaded and unloaded, caps or primers, exclusive of those used for industrial purposes; (c) projectiles, shells, or torpedoes of any kind, including shrapnel, loaded or unloaded, or fuses, or complete rounds of ammunition; (d) firearms of any kind and appendages, including small arms, cannon, machine guns, rifles and bayonets; (e) electric motor boats, submarine or submersible vessels or boats; or (f) any part of any of the articles mentioned in (b), (c), (d) or (e); shall pay for each taxable year, in addition to the income tax imposed by title I, an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for said year from the sale or disposition of such articles manufactured within the United States: *provided, however*, that no person shall pay such tax upon net profits received during the year nineteen hundred and sixteen derived from the sale and delivery of the articles enumerated in this section under contracts executed and fully performed by such person prior to January first, nineteen hundred and sixteen.

(2) This section shall cease to be of effect at the end of one year after the termination of the present European war, which shall be evidenced by the proclamation of the president of the United States declaring such war to have ended.

SEC. 302. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States the following items:

(a) The cost of raw materials entering into the manufacture;

(b) Running expenses, including rentals, cost of repairs and maintenance, heat, power, insurance, management, salaries and wages;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the manufacture;

(e) Losses actually sustained within the taxable year in connection with the business of manufacturing such articles, including losses from fire, flood, storm or other casualty, and not compensated for by insurance or otherwise; and

(f) A reasonable allowance according to the conditions peculiar to each concern for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants.

SEC. 303. If any person manufactures any article specified in section three hundred and one and, during any taxable year or part thereof, whether under any agreement, arrangement, or understanding or other

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wise, sells or disposes of any such article at less than the fair market price obtainable therefor, either (a) in such manner as directly or indirectly to benefit such person or any person directly or indirectly interested in the business of such person, or (b) with intent to cause such benefit, the gross amount received or accrued for such year or part thereof from the sale or disposition of such article shall be taken to be the amount which would have been received or accrued from the sale or disposition of such article if sold at the fair market price.

SEC. 304. On or before the first day of March, nineteen hundred and seventeen, and the first day of March in each year thereafter, a true and accurate return under oath shall be made by each person manufacturing articles specified in section three hundred and one to the collector of internal revenue for the district in which such person has his principal office or place of business, in such form as the commissioner of internal revenue, with the approval of the secretary of the treasury, shall prescribe, setting forth specifically the gross amount of income received or accrued from the sale or disposition of the articles specified in section three hundred and one, and from the total thereof deducting the aggregate items of allowance authorized in section three hundred and two, and such other particulars as to the gross receipts and items of allowance as the commissioner of internal revenue, with the approval of the secretary of the treasury, may require.

SEC. 305. All such returns shall be transmitted forthwith by the collector to the commissioner of internal revenue, who shall, as soon as practicable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before thirty days from the date of such notice.

SEC. 306. If the secretary of the treasury or the commissioner of internal revenue shall have reason to be dissatisfied with the return as made, or if no return is made, the commissioner is authorized to make an investigation and to determine the amount of net profits and may assess the proper tax accordingly. He shall notify the person making, or who should have made, such return and shall proceed to collect the tax in the same manner as provided in this title, unless the person so notified shall file a written request for a hearing with the commissioner within thirty days after the date of such notice; and on such hearing the burden of establishing to the satisfaction of the commissioner that the gross amount received or accrued or the amount of net profits, as determined by the commissioner, is incorrect, shall devolve upon such person.

SEC. 307. The tax may be assessed on any person for the time being owning or carrying on the business, or on any person acting as agent for that person in carrying on the business, or where a business has ceased, on the person who owned or carried on the business, or acted as agent in carrying on the business immediately before the time at which the business ceased.

SEC. 308. For the purpose of carrying out the provisions of this title the commissioner of internal revenue is authorized, personally or by his agent, to examine the books, accounts and records of any person subject to this tax.

SEC. 309. No person employed by the United States shall communicate, or allow to be communicated to any person not legally entitled thereto, any information obtained under the provisions of this title, or allow any such person to inspect or have access to any return furnished under the provisions of this title.

SEC. 310. Whoever violates any of the provisions of this title or the regulations made thereunder, or who knowingly makes false statements in any return, or refuses to give such information as may be called for, is guilty of a misdemeanor, and upon conviction shall, in addition to paying

## *Income Tax Department*

any tax to which he is liable, be fined not more than \$10,000, or imprisoned not exceeding one year, or both, in the discretion of the court.

SEC. 311. All administrative, special, and general provisions of law, relating to the assessment and collection of taxes not specifically repealed, are hereby made to apply to this title so far as applicable and not inconsistent with its provisions.

SEC. 312. The commissioner of internal revenue, with the approval of the secretary of the treasury, shall make all necessary regulations for carrying out the provisions of this title, and may require any person subject to such provisions to furnish him with further information whenever in his judgment the same is necessary to collect the tax provided for herein.

(T. D. 2384, October 24, 1916.)

*Regulations No. 39, concerning the tax imposed by Title III of an act approved September 8, 1916.*

ARTICLE 1. The term "person" when used in these regulations shall be held to include such partnerships, corporations, or associations as are engaged in the manufacture in the United States and in the sale or disposition of the articles enumerated in section 301 of title III of the act of September 8, 1916, or parts thereof, and the term "taxable person" will include such partnerships, corporations, or associations as receive any profit from the manufacture and sale of such articles.

ART. 2. The tax imposed by this title is in addition to that imposed by title I, parts I, II and III, popularly known as the federal income tax law, and is an amount equivalent to 12½ per cent. of the entire net profits received or accrued to every person from the sale or disposition of such of the following named articles as are manufactured in the United States by such person:

(a) Gunpowder and other explosives, except blasting powder and dynamite used for industrial purposes.

(b) Cartridges, loaded and unloaded, caps or primers, exclusive of those used for industrial purposes.

(c) Projectiles, shells or torpedoes of any kind, including shrapnel, loaded or unloaded, or fuses or complete rounds of ammunition.

(d) Firearms of any kind and appendages, including small arms, cannon, machine guns, rifles and bayonets.

(e) Electric motor boats, submarine or submersible vessels or boats.

(f) Any part of any of the articles enumerated in (b) to (e), inclusive. (See art. 13 for definition of parts.)

"Projectiles" as used in this title include any and all missiles to be projected from a gun, cannon, mortar, or other firearm, and will include bullets, balls, shot or other missiles. Under the term "shells" or "torpedoes" is comprehended any receptacle used to inclose an explosive charge, or the receptacle and charge combined.

"Appendages" as used in paragraph (d) will include those adjuncts or accessories appended to firearms not a part of them but which facilitate their use, such as straps, belts, scabbards, shields, holsters, or other appurtenances common to such firearms.

Electric motor boats are those boats, regardless of size or character of construction, which are propelled by electric power.

Submarine or submersible vessels include all craft, no matter how propelled, manufactured for the purpose of being at will submerged beneath the surface of the water.

ART. 3. The effective date of this title is January 1, 1916; that is to say, the tax is laid upon or measured by the net profits received by or accrued to each taxable person for and during the entire calendar year ended December 31, 1916, or so much thereof as during which the person may have been engaged in the business of manufacturing and disposing of such

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articles, and for each calendar year thereafter until one year after the close of the present European war.

ART. 4. Every person subject to the tax imposed by this title shall make a return of annual net profits for the year ended December 31, 1916, and for each calendar year thereafter. (See art. 5.)

ART. 5. The return contemplated by article 4 of these regulations shall set forth the following items:

(1) Total amount of capital employed in the business or properties used in the manufacture of munitions of war or parts thereof.

(2) Total amount of debts or loans the proceeds of which were used in the business.

(3) Gross amount of income received or accrued from the sale or disposition of munitions, or parts thereof, manufactured in the United States.

(4) Cost of raw materials entering into the manufacture of munitions or parts of munitions.

(5) Total amount of expenses of operation and maintenance relating to the business or properties.

(6) Amount of interest paid within the year on debts or loans the proceeds of which were used in the business.

(7) Taxes of all kinds paid within the year with respect to the business or properties used in the manufacture of munitions or parts thereof.

(8) Losses actually sustained and charged off within the taxable year in connection with such business and not compensated for by insurance or otherwise.

(9) Depreciation on property used in but not specially constructed or installed for the business.

(10) Amount apportioned to the year for amortization of the cost of buildings and machinery specially constructed or installed for the manufacture of munitions or parts thereof.

(11) Total amount of net profits upon which the tax is to be computed.

"The business" as used in the foregoing items is held to mean the business of manufacturing and selling or disposing of the munitions or parts thereof enumerated in section 301 of title III.

ART. 6. The return required in accordance with the last preceding article will be made upon blank forms prescribed by the commissioner of internal revenue and approved by the secretary of the treasury. These blank forms may be had of the collectors of internal revenue of the districts in which the taxable persons have their principal places of business.

Failure to procure or receive a blank form for use in making the return will not relieve the taxable person from liability to the penalty imposed by the title if he fails to make a return within the prescribed time.

The return, when prepared, shall be sworn to before an officer qualified to administer an oath, by the owner of the business, if owned by an individual, by two members of the firm, if owned by a partnership, or by two principal officers of the company, if owned by a corporation or association.

ART. 7. When prepared and executed as hereinbefore indicated the return will be filed with the collector of internal revenue of the district in which such person has his principal place of business on or before March 1 next following the calendar year for which the return is made.

The collector will forthwith transmit the return to the commissioner of internal revenue, who, as soon as practicable thereafter, will assess the tax found due and notify the taxable person of the amount so assessed, and such person shall pay the tax to the collector with whom the return was filed on or before the expiration of 30 days from the date of such notice. Failing in this, the taxable person will be liable to a penalty equivalent to 5 per cent. of the amount of the tax assessed.

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ART. 8. All administrative, special and general provisions of law relating to the assessment or collection of taxes, not specifically repealed, are made to apply to this title in so far as applicable and not inconsistent with its provisions.

Under these provisions a failure to file a return within the prescribed time subjects the person making the return to an additional tax of 50 per cent., and also to a specific penalty not in excess of \$10,000, or to imprisonment not in excess of one year, or both, in the discretion of the court: *provided*, that in case of sickness or absence of the person or persons required to make or verify the return, the collector may, upon application, grant an extension of time not exceeding 30 days from March 1, in which case, if the return is filed on or before the last day of the extended period, the additional tax will not be assessed and the penalty will not be asserted: *provided further*, that if the return is not made within the prescribed time, but is voluntarily and without notice from the collector filed after such time, and it is shown that the failure to file it within the time was due to a reasonable cause and not to willful neglect, the 50 per cent. addition will not be made to the tax.

ART. 9. In cases wherein the secretary of the treasury or the commissioner of internal revenue has reason to be dissatisfied with the return as made, or in cases wherein no return is made, the commissioner is authorized to make an investigation and personally or by an agent to examine the books and records of the person and to determine the amount of tax due and to assess the tax accordingly. In such case the commissioner shall notify the taxable person of the result of his finding and the tax shall be collected in the same manner as herein provided, unless such person, so notified, files with the commissioner within 30 days from the date of such notice, a written request for a hearing, in which event, the burden of proof that the amount of taxable income determined by the commissioner was not correct will devolve upon the person against whom the tax was assessed.

ART. 10. The gross income contemplated by this title and to be reported in the return for the purpose of this tax is the gross amount received by or accrued to a taxable person during the year from the sale or disposition of articles named in section 301, which are manufactured within the United States, profits received and accrued from the manufacture and sale of blasting powder and dynamite, and from the manufacture and sale of cartridges, loaded and unloaded, caps and primers used for industrial purposes being excepted, and income received during the year 1916 from the sale and delivery of munitions under contracts executed and fully performed prior to January 1, 1916, being also excepted from liability to this tax.

The income received or accrued from the latter source being exempt from the tax, any expenses incident to the manufacture of such articles and the creation of such incomes will not be deductible from the gross income contemplated by this article.

Income from contracts executed and fully performed prior to January 1, 1916, relates to any deferred payments on such fully performed contracts, which payments, pursuant to contract or otherwise, may not have been received until subsequent to January 1, 1916. The profits represented by such payments having been *earned* prior to the effective date of this title are not subject to this tax although *received* subsequent to that date.

If, however, the contracts were not "fully performed" prior to January 1, 1916, any profits resulting from that part of the contracts performed subsequent to January 1, 1916, must be returned for the purpose of this tax.

"Gross income" as used in this and other articles of these regulations is held to mean gross receipts from the sale or disposition of the



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munitions or parts thereof enumerated in section 301, title III, of the act of September 8, 1916.

ART. 11. The tax may be assessed against the person who may at the time own or carry on the business or who may act as agent for such person, and in case the business ceases during any calendar year, the tax may be assessed against the person who owned or carried on the business at the time it ceased, or against his agent, if he had an agent, carrying on the business. In either case the person against whom the tax is assessed will be held liable for its payment, and to any penalties that may attach by reason of his failure to comply with the requirements of the title.

ART. 12. The amount taxable or by which the tax is measured is the net profits received or accrued from the sale or disposition of any munitions enumerated in section 301, manufactured in the United States, or from the sale or disposition of any parts of the articles mentioned in articles (b) to (e), inclusive, of said section. The only net profits exempt from the tax are those received or accrued to the manufacturer from the sale or disposition of blasting powder and dynamite; cartridges, loaded and unloaded; caps and primers used for industrial purposes. The fact that any of the articles named in section 301 are manufactured and sold or disposed of in the general trade, to be used for sporting purposes, or for any purposes other than industrial, will not exempt from liability to the tax the net profits received or accrued from the sale or disposition of such articles.

ART. 13. "Any part thereof," as used in section 301 of this title, is any article *relatively complete* within itself and designed or manufactured for the special purpose of being used as a component part of a completed munition, and which, by reason of some peculiar characteristic, loses its identity as a commercial commodity, and which, without further treatment, can not be used for any purpose other than that for which it was designed.

A stock or commercial commodity purchasable in the general trade or open market, if adapted to use in the manufacture of a munition, is not a "part" within the meaning of this section, and will be treated as raw material, provided that articles which ordinarily would be classed as commercial commodities become "parts" within the meaning of this title when they are manufactured specially for and sold to a manufacturer to be by him incorporated in and made an essential part of any munitions enumerated in section 301 of this title.

ART. 14. The articles enumerated in (a) and (b) of section 301 as being exempt from the requirements of this title by reason of the fact that they are "used for industrial purposes" include only those articles so enumerated which are used in connection with or in the promotion and operation of some industry.

The net profits received or accrued on any articles named in these paragraphs which are manufactured and sold or disposed of for any purpose other than for use in connection with or in the promotion or operation of some industry will be subject to the tax.

ART. 15. As used in section 302 of this title, and as applied to the manufacture of any part thereof (referring to the articles enumerated in paragraphs (b) to (e), inclusive, of sec. 301), raw materials are held to be any crude or elemental products or substances necessary to the manufacture of such parts, and which, without the application of skill or science, can not become component parts or elements in the finished article or unit.

As applied to the manufacture of completed munitions, raw materials will include not only such crude products and elemental substances, but all essential finished or unfinished parts as well. The cost of raw materials authorized as a deduction will not include any expenditures made for raw materials used in the manufacture of articles other than munitions,

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or parts thereof, in cases wherein the manufacture of such munitions or parts is carried on in connection with any other business. In other words, the only deduction to be made from the gross income contemplated by this title on account of the cost of raw material is the cost of such materials as are actually used in the manufacture of the articles, the profit on the sale or disposition of which is subject to the tax imposed by this title.

ART. 16. Running or general expenses as contemplated by section 302 constitute an allowable deduction from the gross amount of income received or accrued from the manufacture in the United States, and the sale or disposition of munitions or parts thereof, to the extent that such expenses are incurred and paid during the year in the manufacture of articles the profits from the sale of which are included in the gross amount of income returned.

Such expenses will include expenditures for rent, repairs and maintenance, heat, light, power, insurance, management, salaries and wages. In cases wherein other business is carried on in connection with the manufacture and sale or disposition of munitions or parts thereof, and the running expenses of the person making the return cover those incurred in the operation of the entire business and can not be segregated from those incurred in connection with other business, the expenses deductible for the purpose of this tax are such a portion of the entire expenses as the gross income received or accrued from the manufacture and sale or disposition of war munitions or parts thereof is a portion of the entire gross income received or accrued from such entire manufacturing business.

The cost of new buildings, new machinery or equipment should be charged to capital account, to be taken care of through the depreciation or amortization account.

ART. 17. The amount deductible from the gross income received or accrued from the manufacture and sale or disposition of munitions or parts thereof, on account of interest, is the amount of interest actually paid within the year on debts or loans contracted to meet the needs of the business of manufacturing such articles, and the proceeds of which were actually used to meet such needs. This deduction must not include any interest paid on debts or loans the proceeds of which were used to meet the needs of any other business in which the manufacturer may be engaged. This deduction can be taken only from the gross income of the year in which the interest was actually paid.

ART. 18. The taxes deductible under this title are those taxes of all kinds which were actually paid during the year in which the gross income was received or accrued and which were imposed with respect to the business or property relating to or used in the manufacture of articles, the profit from which is returned for the purpose of the tax imposed by this title.

If the taxes paid by a manufacturer of munitions or parts thereof are not segregated from those paid with respect to other business or property, they will be apportioned in accordance with the rule hereinbefore set out for apportioning running expenses, and the amount deductible from the gross income received or accrued from the manufacture and sale of munitions or parts will be the amount thus apportioned and made applicable as a proper charge against the income from the manufacture of munitions or parts thereof.

ART. 19. The amount to be deducted from gross income on account of losses is the amount of losses actually sustained and charged off during the year for which the return is made, and which were sustained on account of, or in connection with, the business of the manufacture and sale or disposition of munitions or parts thereof, and will include losses from fire, flood, storm, accident or other casualties not compensated for

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by insurance or otherwise, the casualty losses referred to being only those which relate to this business.

Losses sustained in connection with collateral investments or in connection with any other business, the profits from which are not taxable under this title, can not be deducted from the gross income contemplated by this title.

ART. 20. The deduction authorized on account of depreciation relates to the loss due to use, wear and tear of physical property owned and used by the manufacturer, but which is not specifically designed or installed for the purpose of manufacturing munitions or parts thereof, and which, without material alteration and change, may be used in connection with any other business in which the person is or may be hereafter engaged.

The annual deduction on this account will be a reasonable allowance determined upon the basis of the cost and probable number of years constituting the life of the property.

If the same building and machinery or other equipment are used coincidentally for purposes other than the manufacture of munitions or parts thereof, then the amount deductible from the gross income returned for the purpose of this title on account of depreciation will be apportioned in accordance with the rule hereinbefore set out for apportioning running expenses, and the deduction from the gross income contemplated by this title will be made accordingly.

ART. 21. Section 302 of this title authorizes a deduction to meet the conditions peculiar to each concern and has for its purpose the amortization of the values of buildings and machinery constituting special plants, which will, except for salvage, have no substantial value to the manufacturer when the contracts executed or to be executed for the manufacture of munitions or parts thereof have been fully performed.

The deduction authorized on this account relates to property (buildings, machinery and equipment) specially constructed or installed for use in the manufacture of munitions or parts thereof, and which when no longer useful for this purpose, can not, without material alteration or change, if at all, be used for any other purpose, the life of which property is substantially coincident with the life of the contracts.

The annual allowance to be deducted on this account will be determined by estimating the probable number of years the property will be used in the manufacture of munitions or parts and by dividing the cost of such property, less estimated salvage, by such probable number of years. The quotient thus obtained will measure the amount to be deducted each year on account of amortization, until the cost of the property has been extinguished. Or the cost of the property may be amortized on the basis of the quantity of munitions or parts thereof manufactured under contracts in connection with the fulfillment of which the buildings and machinery or equipment were specially constructed or installed.

Neither the depreciation nor the amortization deduction allowable in the return made for the purpose of this title will relate to property used in connection with any other business carried on by the manufacturer. Amortization applies only and particularly to those special plants and equipment whose life and value, except salvage, will terminate with the end of the business for which they were erected and equipped. It is to be differentiated from depreciation in that depreciation relates to property whose life and value is not dependent upon or materially affected by its use in the manufacture of munitions or parts thereof.

ART. 22. Section 304 of this title authorizes the commissioner of internal revenue, with the approval of the secretary of the treasury, to prescribe a form for the use of manufacturers of munitions or parts thereof in making returns of annual income received or accrued from this source. Such form has been prescribed, and in addition to a statement of gross

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income and allowable deductions therefrom it calls for certain additional information, which additional information is essential to a correct and completed return.

Every person engaged in the manufacture of any of the articles set out in section 301 will be required to make the return in accordance with this prescribed form, setting forth not only the gross income and the authorized allowances but such other particulars as the form calls for.

ART. 23. Under section 310 of this title these regulations, having been approved by the secretary of the treasury, have the force and effect of law. Any person subject to this title who violates any of its provisions or the regulations, or who knowingly makes false statements in the return required to be made, or refuses to give such information as may be called for in the return form or otherwise, is guilty of a misdemeanor, and upon conviction shall, in addition to paying any tax to which he is liable, be fined not more than \$10,000 or imprisoned not exceeding one year, or both, in the discretion of the court.

### III. TREASURY RULINGS ON SPECIAL EXCISE TAX ON CORPORATIONS (T. D. 2383, October 19, 1916.)

*Regulations No. 38 relative to the special excise tax on corporations, etc.,  
under act of September 8, 1916.*

#### CAPITAL-STOCK TAX LAW.

(Sections 407, 408 and 409, title IV, act of September 8, 1916.)

#### SPECIAL TAXES.

SECTION 407. That on and after January first, nineteen hundred and seventeen, special taxes shall be, and hereby are, imposed annually, as follows, that is to say:

Every corporation, joint-stock company or association, now or hereafter organized in the United States for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States, or any state or territory of the United States, shall pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint-stock company or association, or insurance company, equivalent to 50 cents for each \$1,000 of the fair value of its capital stock and in estimating the value of capital stock the surplus and undivided profits shall be included: *provided*, that in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included. The amount of such annual tax shall in all cases be computed on the basis of the fair average value of the capital stock for the preceding year: *provided*, that for the purpose of this tax an exemption of \$99,000 shall be allowed from the capital stock as defined in this paragraph of each corporation, joint-stock company or association, or insurance company: *provided further*, that a corporation, joint-stock company or association, or insurance company, actually paying the tax imposed by section three hundred and one of title III of this act shall be entitled to a credit as against the tax imposed by this paragraph equal to the amount of the tax so actually paid: *and provided further*, that this tax shall not be imposed upon any corporation, joint-stock company or association, or insurance company not engaged in business during the preceding taxable year, or which is exempt under the provisions of section eleven, title I, of this act.

Every corporation, joint-stock company or association, or insurance company, now or hereafter organized for profit under the laws of any foreign country and engaged in business in the United States shall pay annually a special excise tax with respect to the carrying on or doing business in the United States by such corporation, joint-stock company

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or association, or insurance company, equivalent to 50 cents for each \$1,000 of the capital actually invested in the transaction of its business in the United States: *provided*, that in the case of insurance companies such deposits or reserve funds as they are required by law or contract to maintain or hold in the United States for the protection of or payment to or apportionment among policyholders shall not be included. The amount of such annual tax shall in all cases be computed on the basis of the average amount of capital so invested during the preceding year: *provided*, that for the purpose of this tax an exemption from the amount of capital so invested shall be allowed equal to such proportion of \$99,000 as the amount so invested bears to the total amount invested in the transaction of business in the United States or elsewhere: *provided, further*, that this exemption shall be allowed only if such corporation, joint-stock company or association, or insurance company makes return to the commissioner of internal revenue, under regulations prescribed by him, with the approval of the secretary of the treasury, of the amount of capital invested in the transaction of business outside the United States: *and provided further*, that a corporation, joint-stock company or association, or insurance company actually paying the tax imposed by section three hundred and one of title III of this act, shall be entitled to a credit as against the tax imposed by this paragraph equal to the amount of the tax so actually paid: *and provided further*, that this tax shall not be imposed upon any corporation, joint-stock company or association, or insurance company not engaged in business during the preceding taxable year, or which is exempt under the provisions of section eleven, title I, of this act.

SEC. 408. (Last paragraph.) Every person who carries on any business or occupation for which special taxes are imposed by this title, without having paid the special tax therein provided, shall, besides being liable to the payment of such special tax, be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not more than \$500, or be imprisoned not more than six months, or both, in the discretion of the court.

SEC. 409. That all administrative or special provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this title, and every person, firm, company, corporation, or association liable to any tax imposed by this title, shall keep such records and render, under oath, such statements and returns and shall comply with such regulations as the commissioner of internal revenue, with the approval of the secretary of the treasury, may from time to time prescribe.

### REGULATIONS.

Concerning the special excise tax imposed by section 407, title IV, act of September 8, 1916, on corporations, joint-stock companies or associations, and insurance companies, organized for profit in the United States, and on the capital invested in the United States of foreign companies and associations transacting business in the United States.

### RETURNS, COMPUTATION OF TAX, COLLECTIONS AND PENALTIES

#### Tax imposed.

ARTICLE 1. Section 407 imposes a special excise tax with respect to the carrying on or doing business by corporations, joint-stock companies or associations, or insurance companies, as follows:

#### Corporations in the United States.

(a) Every corporation, joint-stock company or association, or insurance company, now or hereafter organized in the United States for profit and having a capital stock represented by shares, 50 cents for each \$1,000 of the fair value of the capital stock in excess of \$99,000, except as hereinafter indicated; and

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### Foreign corporations.

(b) Every corporation, joint-stock company or association or insurance company, now or hereafter organized for profit under the laws of any foreign country and engaged in business in the United States, 50 cents for each \$1,000 of the capital actually invested in the transaction of its business in the United States. It is provided in cases in which the foreign corporation makes a return of the total amount of capital invested in the transaction of business, both abroad and in this country, that such proportion of \$99,000 as the amount invested in the United States bears to the total amount invested in the United States and elsewhere may be remitted in computing the tax upon the capital invested in the United States.

### *Corporations exempt.*

#### Corporations and associations exempt.

ART. 2. (a) The following corporations, joint-stock companies or associations, or insurance companies, which are exempt from income tax under the provisions of section 11, title I, are also specifically exempt from the capital stock tax under section 407, title IV, of this act:

First. Labor, agricultural or horticultural organization;

Second. Mutual savings bank not having a capital stock represented by shares;

Third. Fraternal beneficiary society, order or association, operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident or other benefits to the members of such society, order or association or their dependents;

Fourth. Domestic building and loan association and co-operative banks without capital stock organized and operated for mutual purposes and without profit;

Fifth. Cemetery company owned and operated exclusively for the benefit of its members;

Sixth. Corporation or association organized and operated exclusively for religious, charitable, scientific or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual;

Seventh. Business league, chamber of commerce, or board of trade, not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual;

Eighth. Civic league or organization not organized for profit but operated exclusively for the promotion of social welfare;

Ninth. Club organized and operated exclusively for pleasure, recreation and other non-profitable purposes, no part of the net income of which inures to the benefit of any private stockholder or member;

Tenth. Farmers' or other mutual hail, cyclone or fire insurance company, mutual ditch or irrigation company, mutual or co-operative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues and fees collected from members for the sole purpose of meeting its expenses;

Eleventh. Farmers', fruit growers' or like association, organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them;

Twelfth. Corporation or association organized for the exclusive purpose of holding title to property, collecting income therefrom and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title; or

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Thirteenth. Federal land banks and national farm loan associations as provided in section twenty-six of the act approved July seventeenth, nineteen hundred and sixteen, entitled "An act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes."

Mutual companies exempt.

(b) Inasmuch as the basis of tax is the fair value of the stock of a corporation, mutual insurance companies and other associations not having capital stock represented by shares will also be exempt from tax, in the absence of a basis for the computation of the tax

### Returns.

Tax due in January and July, 1917, and annually in July thereafter.

ART. 3. (a) Section 3237, *Revised Statutes*, as amended by section 53 of the act of October 1, 1890 (26 Stats., 567), provides "that all special taxes shall become due on the 1st day of July, 1891, and on the 1st day of July in each year thereafter, or on commencing any trade or business on which such tax is imposed. In the former case the tax shall be reckoned for one year, and in the latter case it shall be reckoned proportionately from the 1st day of the month in which the liability to a special tax commenced to the 1st day of July following." The capital stock tax, therefore, which becomes effective January 1, 1917, will be payable in January, 1917, on returns to be made during that month for the six months ending June 30, 1917. In July, 1917, and annually in July thereafter, returns must again be made and the tax paid for the ensuing fiscal year.

Returns required of every United States corporation having capital stock outstanding of \$75,000 or over.

(b) Every corporation, joint-stock company or association, or insurance company, organized in the United States for profit and having a capital stock issued and outstanding, represented by shares of the market value of \$75,000 or over, and not exempt as indicated in article 2, shall make a return on form 707 irrespective of the par value of its capital stock, unless such corporation, joint-stock company or association, or insurance company was not engaged in business during the preceding taxable year, which for the return due January 1, 1917, shall be the fiscal year July 1, 1915, to June 30, 1916.

Return required of every foreign corporation.

(c) Every corporation, joint-stock company or association, or insurance company, organized for profit under the laws of any foreign country and engaged in business in the United States, shall make return on form 708 irrespective of the amount of capital employed either at home or in this country in the transaction of its business.

### Form of return for United States corporations.

Substance of return required from United States corporations.

ART. 4. The return required by article 3 of corporations, joint-stock companies or associations, or insurance companies, organized in the United States, shall be made on form 707, to be supplied by this department, and shall set forth the following particulars:

- (1) Total number of shares of stock now outstanding.
- (2) Par value of shares.
- (3) Par value of total capital stock outstanding.
- (4) Amount of surplus.
- (5) Amount of undivided profits.
- (6) *Case 1.*—Average market value per share during preceding fiscal year, if stock is listed on an exchange.

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*Case II.*—If stock is not listed on an exchange, average market value per share computed from sales made during preceding fiscal year.

*Case III.*—If stock is not listed on any exchange and no sales have been made during preceding fiscal year, or if sales have been made and the price is unknown, the fair average value of the stock may be estimated from the following data set forth on the return: Amount of surplus, amount of undivided profits, nature of business, estimated earning capacity, average dividends per share paid during preceding five years, average profits per share earned during preceding five years.

(7) Total number of shares of stock outstanding on last day of fiscal year.

(8) Fair value of total capital stock for preceding fiscal year.

(9) Deduction allowed by law of \$99,000.

(10) Amount of fair value of stock over \$99,000 upon which tax should be computed.

(11) Tax rate of 50 cents per year for each full \$1,000.

(12) Amount of munitions tax, if any, paid under title III of this act since making the last previous return.

(13) Amount of tax due.

### *Form of return for foreign corporations.*

Substance of return required of foreign corporations.

ART. 5. The return required by article 3 of foreign corporations, joint-stock companies or associations, or insurance companies, having capital invested in the transaction of its business in the United States, shall be made on form 708, to be supplied by this department, and shall set forth the following particulars:

(1) Amount of capital invested in the United States.

(2) Amount of capital invested in foreign countries.

(3) Total amount of capital invested in the corporation, both in the United States and elsewhere.

(4) Percentage of capital invested in the United States.

(5) Percentage of \$99,000 allowed to be deducted under the law.

(6) Amount of capital upon which tax should be computed.

(7) Tax at the rate of 50 cents per year for each full \$1,000.

(8) Amount of munitions tax, if any, paid under title III of this act since making the last previous return.

(9) Amount of tax due.

### *Computation of tax.*

United States corporations.

ART. 6. *Sec. 1. Companies or associations organized in the United States for profit.*—The tax on companies or associations having a capital stock represented by shares is imposed on the fair average value for the preceding year and not the face or par value of the capital stock. The fair value of the capital stock shall be ascertained as follows:

Stock listed on exchange.

(a) *Case I.*—If the stock is listed on any exchange its fair value will be determined by adding the quoted highest bid price for the stock on the last business day of each month during the preceding fiscal year (or if no bid price was quoted on the last day then the latest day in the month on which a bid was quoted), and dividing by 12, the result being the average bid price per share for that year.

Stock not listed, but of which sales have been made.

(b) *Case II.*—If the stock is not listed on any exchange, but sales thereof have been actually made, and the price paid for the stock is known to the officer making the return, or can be discovered by him, the average price at which sales were made during the preceding fiscal year shall be the determining factor in ascertaining the fair value per share.



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(In the foregoing two cases the actual fair value of the stock is ascertainable from the facts without the necessity of making an estimate.)

Cases in which fair average value of stock shall be estimated.

(c) *Case III.*—If case I and case II can not be applied, viz., the stock is not listed on any exchange, and no actual sales have been made during the preceding fiscal year, or if the price at which sales have been made is not known to the officer making the return the fair average value of the capital stock shall be estimated, and the surplus and undivided profits for the preceding fiscal year will be taken into consideration as required by the statute, as well as the nature of the business, its earning capacity and average dividends paid, or profits earned during the preceding five years.

Fair value of total capital stock outstanding.

(d) The fair value per share ascertained or estimated as above multiplied by the number of shares outstanding will give the fair value of the stock for taxation purposes.

Deduction of \$99,000.

(e) From this total will be deducted the sum of \$99,000, the exemption allowed by law, and the tax will be laid upon the balance at the rate of 50 cents for each full \$1,000 of the remainder.

Tax due January, 1917.

(f) Upon the returns to be made during January, 1917, for the six months ending June 30, 1917, the tax due will be 25 cents per \$1,000 of such remainder.

Deduction of munitions tax.

(g) From the tax due as so determined will be deducted the amount of munitions tax, if any, actually paid since making the last previous return. As the special excise tax on capital stock is due in January, 1917, and the munitions tax will not be determined and assessed until March or April, no deductions for munitions tax will be allowed on the January, 1917, return. Deductions, however, will be allowed on the July, 1917, return for munitions taxes actually paid prior to that date.

*Sec. 2. Corporations, joint-stock companies or associations, or insurance companies, organized for profit under the laws of any foreign country and engaged in business in the United States.*

Foreign corporations.

(a) The tax imposed on such companies or associations shall be computed upon the actual capital invested in the transaction of its business in the United States. The basis of taxation is the *average* amount of capital so invested during the preceding fiscal year.

Deduction of proportion of \$99,000 only allowed if corporation makes return of total capital invested.

(b) The exemption from the amount of capital invested in the United States equal to the proportion of \$99,000 as the amount so invested bears to the total amount invested in the transaction of business in the United States or elsewhere shall only be allowed a company or association which makes return to the commissioner of internal revenue, under these regulations, of the amount of capital invested in the transaction of business outside of the United States. Thus a foreign company or association investing part of its capital in the transaction of business in the United States shall be liable for tax in the amount of 50 cents for each \$1,000 of the actual capital invested in the United States, without deduction of the said proportion of \$99,000, unless it discloses in its return the amount of capital invested in the transaction of business outside of the United States.

Corporations not in business during preceding taxable year.

*Sec. 3. Corporations not engaged in business during preceding taxable year.*—This tax shall not be imposed upon any corporation, joint-stock company or association, or insurance company not engaged in business

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during the preceding taxable year, or in the case of the taxable period ending June 30, 1917, not so engaged during the year July 1, 1915, to June 30, 1916. The tax shall be computed upon each full value of \$1,000 and not on any fractional part thereof.

### *Collection of tax.*

Special list, form 23c.

ART. 7. On account of the impracticability of issuing stamps in the various amounts, this tax will be collected by assessment on a special list for the months of January and July, 1917, and annually thereafter in July. Any delinquent returns made in February or other months, or any assessments for delinquency in taxes, may be listed on the regular list form 23, and collected in the usual way.

Returns retained by collector.

(a) Returns listed on special lists will be retained in the office of the collector as the special list will be prepared so as to give the essential data shown by the return.

Returns forwarded to commissioner.

(b) Returns listed on regular lists will be forwarded to this office with the list for audit.

Penalty of 5 per cent.

(c) Upon failure to pay the tax assessed within 10 days after notice and demand, a penalty of 5 per cent. of the tax unpaid and interest at the rate of 1 per cent. per month until paid shall be added to the amount of such tax.

### *Penalties.*

Administrative and assessment laws applicable to this law.

ART. 8. (a) Under section 409 it is provided that "all administrative or special provisions of law, including the law relating to the assessment of taxes so far as applicable, are hereby extended to and made a part of title IV, and every person, firm, company, corporation, or association liable to any tax imposed by this title shall keep such records and render under oath such statements and returns as shall comply with such regulations as the commissioner of internal revenue, with the approval of the secretary of the treasury, may from time to time prescribe."

Penalties for failure to make return.

(b) Any company or association, therefore, subject to special tax under section 407 of this act, which fails to make returns during the months of January, 1917, and July, 1917, and annually in July thereafter, will be liable to the penalties imposed by section 3176, *Revised Statutes*, as amended by section 16, act of September 8, 1916, which reads as follows:

Collector may make the return.

If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. Any return or list so made and subscribed by a collector or deputy collector shall be prima facie good and sufficient for all legal purposes.

Extension of 30 days.

If the failure to file a return or list is due to sickness or absence the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

Fifty per cent. penalty.

The commissioner of internal revenue shall assess all taxes, other than stamp taxes, as to which returns or lists are so made by a collector or

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deputy collector. In case of any failure to make and file a return or list within the time prescribed by law or by the collector, the commissioner of internal revenue shall add to the tax fifty per centum of its amount except that, when a return is voluntarily and without notice from the collector filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the commissioner of internal revenue shall add to the tax one hundred per centum of its amount.

The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax.

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### State Board of Public Accountancy of Texas

At an examination held by the state board of public accountancy of Texas on August 14th last, out of eleven applicants only one passed the examination. It is expected that another examination will be held at Fort Worth on December 21st, 22nd and 23rd.

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### Virginia State Board of Accountancy

At the examinations held by the Virginia state board of accountancy on October 11, 12 and 13, 1916, twelve applicants set. The successful candidates were L. B. Harvey, Roanoke, and R. L. Bateman, Norfolk.

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### Pennsylvania Board of Examiners

Horace P. Griffith, C.P.A., of Philadelphia, has been appointed a member of the Pennsylvania board of examiners.

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A. Wenzelburger announces that E. M. Shipley has become associated with him in the practice of accountancy under the name of Wenzelburger and Shipley, certified public accountants, with offices in the Foxcroft building, 68 Post Street, San Francisco, California.

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E. E. Dadson, C.P.A., L. D. Burnell and Wm. C. Rowland, C.P.A., announce the formation of a partnership under the firm name of Dadson, Burnell and Rowland, with offices in the Dime Savings Bank building, Detroit, Michigan.

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W. H. Dennis, C.P.A., and Eugene V. Young, C.P.A., have formed a partnership under the firm name of Dennis and Young, at 87 Nassau Street, New York.

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The Mainwaring, Raffel, O'Brien Company announces its formation with offices in the Mayo building, Tulsa, Oklahoma.

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Jasper & Herington announce the removal of their offices to 110 West 40th Street, New York.

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R. E. Brotherton, C.P.A., of Oakland, California, announces the opening of branch offices in the Chronicle building, San Francisco.

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A. F. Rattray Grieg announces the removal of his office from 4208½ Berkeley Avenue to 4552 Ellis Avenue, Chicago, Illinois.

## Students' Department

EDITED BY SEYMOUR WALTON, C. P. A.  
A SIMPLE AMORTIZATION METHOD

When the ordinary person encounters the formulas given in the text books, by means of which the premium to be paid on bonds bearing one rate of interest is determined in order that a different rate may be realized, he is appalled at the difficulty of the task that confronts him. It requires the division of \$1.00 by an amount representing \$1.00 plus the effective rate of interest to find the present value of the annuity purchased by the premium for the first year, then by the square of 1 plus the effective rate to find the amount for the second year, then by the cube to find the amount for the third year, and so on up to the 20th power, if there are twenty years. If the coupons are paid semi-annually it will require raising 1 plus half the effective annual rate to the 40th power. If bonds bearing 6 per cent. for 20 years are to be bought on a 5 per cent. basis, it will require raising 1.05 to the 20th power on the annual basis, or 1.025 to the 40th power on the semi-annual basis. The 20th power of 1.05 contains 40 decimal places and the 40th power of 1.025 runs to 120 places. It is no easy task to find all these powers, still less to divide \$1.00 by each of them. It is a comparatively easy matter to solve the question by logarithms, but since few persons know how to use logarithms, I shall attempt to show a simple method of doing it by arithmetic.

The suggested method is based on the principle that as \$1.00 is 105 per cent. of .95238, the present value of the annuity for the first period, so this amount of .95238 is 105 per cent. of the present value of the annuity for the second period, which would therefore be .90703. Continuing the process for the twenty periods and adding the results would give the total premium to be paid.

Dividing each of the twenty successive amounts by 105 is a very small task, compared with that which is necessitated by following the usual formula and dividing \$1.00 by the powers of 1.05 up to the 20th with its 40 places of decimals.

The following problems will illustrate both methods.

### PROBLEM

X & Y are dealers in bonds and securities, sharing profits and losses in the proportion of X three-fourths and Y one-fourth. They employ Z to sell securities, agreeing to pay him, in lieu of a salary, an amount equal to 25 per cent. of the net profits to be divided between the partners. During the period of Z's employment the firm purchase \$100,000 Topeka Traction Company first mortgage 5 per cent. bonds, on a 3 per cent. basis. The bonds mature in one year and one-half. Interest is payable semi-annually. These bonds are held by X & Y until maturity.

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Prepare statement of the Topeka Traction Company bond accounts, showing cost, amortization and interest. The total profit to be adjusted in the contract with Z is \$15,000. Show the division of this profit.

### *Solution*

The first question is to find the amount paid for the bonds and premium.

Since the bonds are purchased on a three per cent. basis, the \$5,000 of annual interest or the semi-annual instalments of \$2,500 must be divided between income and amortization of premium. For instance, when the first instalment of \$2,500 is received it must be divided as follows:

\$1,500	Semi-annual interest at 3% on the par of the bonds (income)
1,000	} Interest at 3% on the premium paid (income)
	} Amortization of the premium (principal)

Therefore, when purchasing the bonds they pay:

Par of bonds \$100,000.00

A sum which with interest at 3% will amount to \$1,000 at the end of  $\frac{1}{2}$  year.

A sum which with interest at 3% will amount to \$1,000 at the end of 1 year.

A sum which with interest at 3% will amount to \$1,000 at the end of  $1\frac{1}{2}$  years.

The total of these four items is the actual principal invested.

That is, in addition to par, they pay:

- A. Present value of \$1,000 due in  $\frac{1}{2}$  year at 3% (or in 1 year at  $1\frac{1}{2}\%$ ).
- B. " " " 1,000 " " 1 " " 3% (" " 2 years "  $1\frac{1}{2}\%$ ).
- C. " " " 1,000 " "  $1\frac{1}{2}$  years " 3% (" " 3 " "  $1\frac{1}{2}\%$ ).

The present value of:

A is a sum which, invested at  $1\frac{1}{2}\%$  or .015 will amount to \$1,000 in 1 year, and is calculated as follows:

$$\begin{aligned}
 & \$1.00 \text{ invested at } 1\frac{1}{2}\% \text{ for 1 year will amount to} \\
 & \$1.015 \\
 & \$1,000 \div 1.015 \qquad \qquad \qquad = \$ \quad 985.22
 \end{aligned}$$

B is a sum which, invested at .015 compound interest will amount to \$1,000 in 2 years, and is computed as follows:

$$\begin{aligned}
 & \$1.00 \text{ compounded at } 1\frac{1}{2}\% \text{ for 2 years will amount} \\
 & \text{to } \$1.015 \times 1.015 = \$1.030225 \\
 & \$1,000 \div 1.030225 \qquad \qquad \qquad = \$ \quad 970.66
 \end{aligned}$$

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C is a sum which, invested at .015 compound interest will amount to \$1,000 in 3 years and is computed as follows:

$$\begin{aligned} & \$1.00 \text{ compounded at } 1\frac{1}{2}\% \text{ for 3 years will amount} \\ & \text{to } \$1.015 \times 1.015 \times 1.015 = \$1.045578375 \\ & \$1,000 \div 1.045578375 \qquad \qquad \qquad = \$ \quad 956.32 \end{aligned}$$

Total premium paid	2,912.20
Add par of bonds	\$100,000.00
<hr/>	
Total amount of investment	\$102,912.20

Thus we see that the amount paid for the bonds is par plus the present value of an annuity of \$2,000 for 1½ years at 3% compounded semi-annually, which is equivalent to the present value of an annuity of \$1,000 for 3 years at 1½%.

The total interest collected at 5% for 1½ years would be	\$7,500.00
Deducting the premium paid	2,912.20
<hr/>	

Leaves the net income (as shown in the statement below) \$4,587.80

**X. & Y.**

Statement of Topeka Traction Company Bond Accounts.

	Date	
Bonds and premium—cost		\$102,912.20
End of first six months:		
Cash received—2½% of \$100,000	2,500.00	
Interest for ½ year @ 3% on \$102,912.20 (credit interest)	1,543.68	
		<hr/>
Amount credited to bond account in reduction of premium		956.32
		<hr/>
Balance of bonds and premium		101,955.88
End of second six months:		
Cash received—2½% of \$100,000	2,500.00	
Interest for ½ year @ 3% on \$101,955.88 (credit interest)	1,529.34	
		<hr/>
Amount credited to bond account in reduction of premium		970.66
		<hr/>
Balance of bonds and premium		100,985.22

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End of third six months:

Cash received—2½% of \$100,000	2,500.00
Interest for ½ year @ 3% on \$100,985.22 (credit interest)	1,514.78
	985.22

Amount credited to bond account in reduction of premium 985.22

Balance—par of bonds	\$100,000.00
Cash received in payment of bonds	\$100,000.00

Or the statement may be set up as follows:

<i>Entries at end of:</i>	<i>Debit</i> <i>Cash</i>	<i>Credit</i> <i>Interest</i>	<i>Credit</i> <i>Bond</i> <i>Premium</i>	<i>Balance</i> <i>Bonds &amp;</i> <i>Premium</i>
				\$102,912.20
First six months	\$2,500.00	\$1,543.68	\$ 956.32	101,955.88
Second six months	2,500.00	1,529.34	970.66	100,985.22
Third Six months	2,500.00	1,514.78	985.22	100,000.00
	\$7,500.00	\$4,587.80	\$2,912.20	
Bonds paid				\$100,000.00

These present values and the resulting premium can, however, be determined much more easily by a method based on the following reasoning:

To find the present value of the first \$1,000:

$$1,000 \div 1.015 = 985.22$$

To find the present value of the second \$1,000:

This calculation was performed above as follows:

$$\begin{aligned} & \$1,015 \times 1.015 = \$1,030.225 \text{ amount of } \$1 \text{ in 2 years} \\ & \$1,000 \div 1.030225 = \$970.66 \end{aligned}$$

The process could be stated by the following formula:

$$\frac{\$1,000}{1.030225} = \$970.66$$

Or, factoring the divisor, the formula could be stated:

$$\frac{\$1,000}{1.015 \times 1.015} = \$970.66$$

Changing the method of expressing the division:

$$\frac{\$1,000}{1.015} \div 1.015 = \$970.66$$

But, since the term  $\frac{\$1,000}{1.015}$  has been found to be

\$985.22, we can, by substitution state the equation:

$$\$985.22 \div 1.015 = 970.66$$

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To find the present value of the third \$1,000 :

By the same reasoning,

$$\$970.66 \div 1.015 = \underline{956.32}$$

Total premium 2,912.20

Since Z is to receive "as salary an amount equal to 25% of the net profits to be divided between the partners," the total profit of \$15,000 is 125% of the divisible net profits.

$\$15,000 \div 125\% = \$12,000$ , amount to be divided between X & Y.

The profits are divided as follows :

25% of \$12,000 = 3,000 Z's salary

$\frac{3}{4}$  of \$12,000 = 9,000 X's share of profit

$\frac{1}{4}$  of \$12,000 = 3,000 Y's share of profit

                      
\$15,000 total

### PROBLEM

A company purchased a piece of real estate for \$100,000.00. The terms of payment agreed upon were \$10,000.00 each year thereafter, without interest, until the whole \$100,000.00 was paid. At the end of the fourth year, twelve months before the fifth payment was due, the company found itself possessed of considerable available cash, and decided to relieve itself of the liability specified by depositing one amount sufficient to pay the annual instalments as they matured. The bank agreed to pay 5% interest compounded annually on all money deposited for that purpose.

What is the single amount which the company must deposit, at 5% to pay the yearly instalments as they mature?

### SOLUTION

There are six payments of \$10,000 each yet to be made, and in depositing a lump sum the company pays into the bank the total of the present value of each of the six instalments; as follows :

Present value of \$10,000 due in 1 year
" " " \$10,000 " " 2 years
" " " \$10,000 " " 3 "
" " " \$10,000 " " 4 "
" " " \$10,000 " " 5 "
" " " \$10,000 " " 6 "

The present value of \$10,000 due in 1 year is found thus :

$$\$10,000 \div 1.05 = \$9,523.809$$

The present value of \$10,000 due in 2 years could be found thus :

$$1.05 \times 1.05 = 1.1025, \text{ the amount of } \$1.00 \text{ at } 5\% \text{ for } 2 \text{ years.}$$

$$10,000 \div 1.1025 = \$9,070.29.$$

But when there is a large number of periods involved in the calculation, that is, when a large number of periodical payments must be made,



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the divisors run into very long decimal fractions, and a method based on the reasoning in the previous problem should be used.

From this reasoning we obtain the following procedure:

Divide the amount due at maturity by 1 plus the rate, or 1.05 to obtain the present value of the first payment, thus:

$$\$10,000 \div 1.05 = \qquad \qquad \qquad \$9,523.809$$

Divide the present value of the first payment by 1.05 to obtain the present value of the second payment, thus:

$$\$9,523.809 \div 1.05 = \qquad \qquad \qquad 9,070.294$$

And so forth as follows:

To find the present value of the third payment,  $\$9,070.294 \div 1.05 = 8,638.375$

" " " " " " " fourth "  $8,638.375 \div 1.05 = 8,227.024$

" " " " " " " fifth "  $8,227.024 \div 1.05 = 7,835.261$

" " " " " " " sixth "  $7,835.261 \div 1.05 = 7,462.151$

Making the total of the present values on the lump sum to be paid to the bank \$50,756.914

NOTE: In these calculations it is well to carry the division beyond the cents.

### Proof

	<i>Time</i>	<i>Interest Earned</i>	<i>Annual Payment</i>	<i>Balance In Bank</i>
Beginning of first year				50,756.91
End	" " "	2,537.85	10,000	43,294.76
"	" second "	2,164.74	10,000	35,459.50
"	" third "	1,772.98	10,000	27,232.48
"	" fourth "	1,361.63	10,000	18,594.11
"	" fifth "	929.70	10,000	9,523.81
"	" sixth "	476.19	10,000	0
	Total interest	9,243.09	60,000	
	Add lump sum deposited	50,756.91		
	Total of payments	60,000.00		

### MUTUAL FIRE INSURANCE

*Editor, Students' Department:*

SIR: Will you please be kind enough to advise through the columns of your department, the proper treatment of the following:

January 1, 1913, an insurance policy is purchased in a mutual company: Blank Co. policy No. 1; three year term, premium \$1,500, with dividend at end of term. The entries may be:

Deferred accounts

January	1, 1913	Insurance paid in advance	\$1500	
		To cash		\$1500
December	31, 1913	Insurance	500	
		To insurance paid in advance		500
"	31, 1914	Insurance	500	
		To insurance paid in advance		500
"	31, 1915	Insurance	500	
		To insurance paid in advance		500

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Up to this point the matter is simple. Cost of production has been burdened with \$500 each year for insurance paid.

January 1, 1916, the policy is renewed, policy No. 2, and a second premium of \$1,500 is paid, less a 40 per cent. dividend on policy No. 1, making the net premium on policy No. 2, \$900. We may proceed as in the first term, but the cost of insurance for each subsequent year is but \$300 and the value of comparison is destroyed, as the percentage of dividend is unknown at the time the insurance is placed and there is no assurance that it will be 40 per cent., or any other known per cent. during the period, January 1, 1916, to January 1, 1919.

Nothing seems to be gained by charging the second premium at \$1,500 for comparison purposes, and crediting the dividend of \$600 direct to surplus. This treatment produces a credit in the second period that accrued in the first.

If a certain amount of insurance was taken on and that amount maintained through a period of years the effect would be of no account, but as principals, premiums and dividends are constantly changing it seems to me that the difference is of considerable importance.

Yours truly,

ERNEST B. FRANCIS.

I think that a proper analysis of the conditions will clear the matter. In a mutual fire insurance the rate charged is the standard rate, as fixed by the board of underwriters for stock companies. If the standard premium amounts to \$1,500.00 for three years, that is the proper cost of the insurance and is a correct charge against operating profits spread over the three years.

When a return of part of this payment is made at the end of three years, it is a proper credit to surplus, but not as a rebate of insurance. It is a profit made by the manufacturing company as a part of the insurance company, and, as it is a profit made in an outside business, it is not a credit to operating profits. It is similar to dividends received from an investment in the stock of an outside company which happens to pay dividends at the end of three years, instead of annually.

The reason for this is that the manufacturing company is acting in a dual capacity when it takes out a policy in a mutual company. As the holder of the policy it is paying for insurance. Since the owners of a mutual company are the policy holders, the manufacturing company, as a part owner of the insurance company, is engaged in the insurance business. Therefore, it is both an insured risk and an insurer. As insured it pays the full insurance premium. As insurer it makes a profit on the business, which is a financial profit and not saving on its own insurance.

### APPROXIMATING INVENTORY--PROBLEM

You are called on to confirm the inventory of a mercantile establishment.

Investigation shows that inventories have been incorrectly taken, and are padded.

It is mutually agreed that all inventories, except the first one, which is to be used as the basis, shall be entirely ignored.

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You are to ascertain from the books, on a fixed percentage of profit, which it is decided shall be 33 1-3% of sales, what stock should be on hand Dec. 31, 1914, with the following data obtained from the various books:

On January 1, 1911, the inventory referred to as a basis was	\$47,350.29
For the year ended December 31, 1911, the gross purchases were	76,320.15
Returned purchases	4,350.16
Freight and drayage on purchases	325.14
The gross sales were	115,469.31
Returned sales	1,317.12
<hr/>	
For the year ended Dec. 31, 1912, the gross purchases were	65,506.80
Returned purchases	3,715.16
Freight and drayage on purchases	417.15
The gross sales were	105,716.10
Returned sales	1,215.84
<hr/>	
For the year ended Dec. 31, 1913, the gross purchases were	62,517.10
Returned purchases	1,314.17
Freight and drayage on purchases	316.17
The gross sales were	101,317.18
Returned sales	1,216.06
<hr/>	
For the year ended Dec. 31, 1914, the gross purchases were	58,715.16
Returned purchases	287.50
Freight and drayage on purchases	290.10
Gross sales were	95,371.16
Returned sales	417.11
<hr/>	

### *Solution*

Since the percentage of gross profit is constant throughout the four years, and since only the final inventory is required by the problem, the data can be summarized and the four years' totals used in the inventory calculation.

Summary 1911-1914					
<i>Year.</i>	<i>Purchases</i>	<i>Returned purchases</i>	<i>Freight</i>	<i>Sales</i>	<i>Returned Sales</i>
1911	\$76,320.15	\$4,350.16	\$325.14	\$115,469.31	\$1,317.12
1912	65,506.80	3,715.16	417.15	105,716.10	1,215.84
1913	62,517.10	1,314.17	316.17	101,317.18	1,216.06
1914	58,715.16	287.50	290.10	95,371.16	417.11
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	\$263,059.21	\$9,666.99	\$1,348.56	\$417,873.75	\$4,166.13

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### Statement to Approximate Inventory At December 31, 1914

Inventory, January 1, 1911		47,350.29	
Add:			
Cost of goods purchased 1911-1914:			
Purchases	263,059.21		
Less returned purchases	9,666.99		
	253,392.22		
Net purchases		253,392.22	
Add freight	1,348.56	254,740.78	302,091.07
Deduct:			
Cost of goods sold, 1911-1914:			
Sales		417,873.75	
Less returned sales		4,166.13	
		413,707.62	
Net sales		413,707.62	
Deduct gross profit (33 1-3% of sales)		137,902.54	275,805.08
Inventory December 31, 1914 (estimated)			\$26,285.99

We give this problem, not because there is anything difficult about it, but for the sake of illustrating the way in which time can be saved in an examination. The principle should be grasped that when the conditions are the same throughout the result will be identical if the entire four years are considered as one period, instead of using the conventional division into separate years to reach the cumulative effect. In other words, the whole is equal to the sum of all its parts.

#### DONATED SURPLUS

*Editor, Students' Department:*

SIR: A corporation was recently formed to take over another business. Only a portion of the accounts receivable was taken over at the time of purchase, and stock was issued to proprietor for amount agreed upon.

Proprietor of business taken over is president of corporation and owns all the stock issued.

He has now turned over to the corporation balance of accounts receivable remaining on old books and amounting to \$8,000 and has agreed to accept \$4,000 in stock of corporation in full payment. This is done to create a surplus on corporation books.

How would you record the transaction on corporation's books? Should the surplus created be carried in the regular surplus account?

Very truly yours,

H. R.

Montclair, New Jersey.

The entry to be made on the corporation books would be

Accounts receivable	8,000	
John Brown (the president)		4,000
Surplus		4,000

The next entry would depend on the source of the stock issued to the president. If all the original stock was properly put on the books, but

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was not all issued, there should be a debit balance in unissued stock account. When \$4,000 of this was issued the entry would be

John Brown	4,000	
Unissued stock		4,000

If only the issued stock has been credited to capital stock, the credit of \$4,000 would be to capital stock.

The fact that the \$4,000 surplus was donated does not change its character as surplus. Surplus is any excess of assets, properly valued, over liabilities and capital. As this surplus arose from the donation of the accounts, any loss on those specific accounts should be charged directly to surplus, and not to profit and loss, since it would not be a loss due to the operations of the business, but would be a reduction of the original credit to surplus.

If the president wished to make it a condition of his donation that the \$4,000 should always remain in the company to give it more working capital, and that it should not be used at any time for the payment of dividends, it should not be credited to the regular surplus, but to permanent surplus or donated surplus. The agreement with the president would constitute a contract which would remove the credit from any control by the directors without the express consent of the president. In the absence of such contract the directors could use the money for dividends, although it would be practising a deception on the stockholders if they allowed the latter to believe that the dividend was paid out of profits.

### APPRAISING FIXED ASSETS

#### *Editor, Students' Department:*

SIR: An attempt is being made to analyze the capital assets, building, machinery, equipment, etc., arriving at separate values for these items, in order to state them in an exhibit appended to the balance sheet. This would, of course, be an easy matter if all the records supporting the charges to the plant account were intact, but in this case they are not available.

In a reorganization of the office about five years ago it was found that all items entering into the plant account had been bunched in one account, regardless of whether the charge was for building, machinery, cars or any other item, depreciation having been figured at 5 per cent. per annum. Upon an investigation it was found that most of the records, which supported the entries making these charges, in the way of invoices, vouchers, etc., had been lost and it was impossible to get at any kind of an accurate analysis of the plant account. Since the time of the above-mentioned reorganization a detailed analysis of all additions, betterments and replacements has been kept and it would be an easy matter to analyze them, but the difficulty is in arriving at an equitable and reasonable value of the different assets as they existed prior to the above mentioned reorganization.

We had an appraisal made about two years ago, but I hardly think it would be well to bring the figures up to those shown by the appraisal—as a matter of fact I am certain that the values stated therein are too high. The only plan that suggests itself to me is to bring the different values, as shown in the appraisal, down to the book values, as of the date of the appraisal, using the ratio of the total appraised value to the

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book value and reducing the different items (buildings, machinery, cars, track and sidings) on the basis of this ratio; then adding the actual cost of whatever additions have been made since.

While, of course, this method is highly arbitrary, there does not seem to be any other that would answer the required purpose, seeing that no records prior to 1911 are available.

I might state that this is a close corporation and other than the regular income tax reports we are not required to submit any statements to any one, and the balance sheets have always been passed by the auditors as reflecting the true value of the capital assets, but they have never, so far as I know, made any effort to separate them.

Conditions are rapidly approaching a point, however, where, I think, for our own information it will be necessary for us to place a value on the different plant items. I think the book value as shown at the present time is about the correct valuation for the total plant investment, and I want to make these values equal the book value at the present time.

Any comments by the way of suggestions or criticisms you may care to make regarding the above proposition will be greatly appreciated.

Yours very truly,

G. A. G.

Knoxville, Tennessee.

This situation is similar to that in which the railroads found themselves when the interstate commerce commission told them to separate into its constituent elements the account of road and structures which had hitherto been carried by most of them as a single account. In many cases the vouchers had been lost or destroyed, and even in those instances where the data were in existence, the documents were so numerous and so difficult to find that it would have been an Herculean task to tabulate the information contained in them. The commission cut the Gordian knot by allowing the roads to make one lump sum valuation of "road and structures prior to June 30, 1907," but requiring them to classify all additions made since that date.

Where it is easy to have an appraisal made of all the property, as in the case cited by our correspondent, there is a reasonable basis on which to make a valuation of the different parts of the plant and equipment. While it is by no means certain that these values are exactly what proper cost records would show, it is quite true that the valuation he proposes would be as nearly correct at the time of the appraisal as it is possible to ascertain it. The total book value being accepted as correct, the detailed valuation would undoubtedly be in proportion to the values shown by the appraisers.

Our correspondent is also right in saying that he does not think the values should be written up to correspond with the appraisal. Accountants usually find that appraisers are too liberal in their valuations. They are too apt to make the working value approximate too closely to the insurable value. In calculating the life of a machine it is not correct to consider the number of years during which the machine will be capable of doing some work. Its life as a valuable asset may be ended when it ceases to do sufficiently effective work to make it worth while to keep it going. By the time its usefulness has fallen below a certain point,

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the expense of running it and of constantly repairing it, in proportion to the amount of its output, may make it cheaper to scrap it and buy a new machine.

If the values are written up, the offsetting credit should be to reserve for depreciation and not to surplus. This, of course, amounts to not writing up the book value at all, as the net carrying value will be the same. Its only advantage is the placing of the gross value at what may be considered a proper figure. The exception to this would arise in case it were determined that the amount of depreciation written off in the past had been too great. In this case, the charge should be to reserve for depreciation and the credit to surplus. As operating expenses have been charged too much in the past by excessive depreciation, the surplus has suffered by having received credit for too small an amount of operating profit. The credit to surplus is merely restoring that account to the position that it would have had if depreciation had been properly treated. It is a correction of past errors and is not in any sense a profit.

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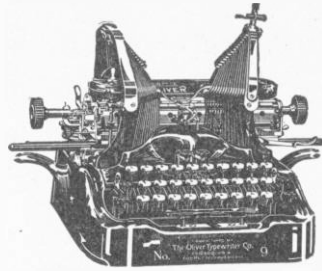
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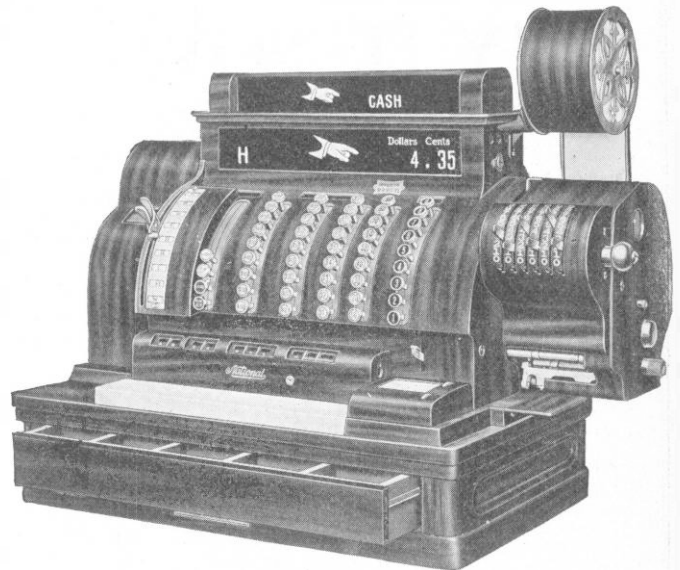
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