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The JOURNAL *of* ACCOUNTANCY

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A. P. RICHARDSON, *Editor*

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EDITORIAL

"Firm-Name" Legislation Opposed

In several recent issues of THE JOURNAL OF ACCOUNTANCY, we have referred to a movement in certain states toward the enactment of legislation which would prevent the use of firm names by accountants except when every name in the firm represents an actual living and resident partner. The obvious unfairness of such an attempt to restrict the practice of accountancy evidently is deplored by representative members of the profession, for we find that at the semi-annual meeting of the council of the American Institute of Accountants, held in New York, April 13, 1936, the committee on state legislation presented a resolution opposing legislation of this sort. The text of the resolution was quite clear and emphatic in its opposition, and it is noteworthy that it was passed without a single dissenting vote by men who had come from all sections of the country, from Massachusetts to California and from the north to the extreme south. The text follows:

"Whereas bills have recently been introduced in state legislatures which would make it unlawful for public accounting firms to practise under firm names which include names of individuals other than those active in the firms, and

"Whereas there is no known general public need or demand for such legislation, and

"Whereas the effect of such legislation would be to prohibit the following by public accountants of a procedure as to firm names which is followed in other professions and by business firms and which in some cases is specifically permitted by statute, and

"Whereas such legislation would require many changes in firm names, might result in inconsistent requirements in neighboring states and would add to the burdens of business concerns and others who use public accountants' reports and would tend to lessen their respect and esteem for the accounting profession,

"Be it resolved that the council of the American Institute of Accountants is of the opinion that so-called 'firm name' legislation of the type hereinbefore described is not needed and that if enacted it would be detrimental to the best interests of the accounting profession and of the business public."

By-products of Bidding

The sentiment of accountants against the practice of competitive bidding for municipal or other work is so widespread and so fundamental that some of the less conspicuous evils of the custom are sometimes overlooked. One of the pernicious effects of bidding is due to the probability that those who bid may be the least competent—even perhaps the least honest—and the tendency of uninformed city fathers is to accept the lowest bid, irrespective of the personality or reputation of the bidder. We have received from a correspondent a letter describing the fate of one city far from New York. In that city there are probably dozens of accountants and most of them are competent and of high standing. The local government called for bids for the audit of the city's books, but the great majority of accountants neglected or refused to reply in any way. Two bids were submitted, one of them considerably more than twice the amount of the lower bid. The city accepted the lower bid. We find, therefore, that in a community in which there is an abundance of accounting ability, the city's own affairs are subjected to audit by an accountant who is probably not the leader of his profession in that locality. When most accountants refuse to bid one is naturally skeptical of the ethical standards of a minority which consents to bid, and when of the bidders one quotes a fee far less than half of the other bid, one may be forgiven a little uncertainty as to the value of the work which the selected bidder will do. This incident occurred in a city of great importance, and it does not speak well for the mentality or the discernment of those who have the control of local government that they should disregard the interests of the entire community and award, solely on the basis of cheapness, the highly important duty of investigating the state of the city's finances and reporting to the people. Here, if ever, was a case of calling for bids which carried its own condemnation with it.

Professional Classification of Accountancy

Twenty or thirty years ago there were a few obtuse persons who still felt that accountancy was not a profession. Some of them described themselves as accountants, but they maintained that accountancy was simply a business matter and should be conducted like the sale of food or clothing or commodities. Gradually however, this misconception of the true nature of accountancy has faded away and among business men and the public generally accountancy is recognized as one of the great professions. It is interesting to watch the development of accountancy's prestige. For example, in a recent case in Hawaii, Judge Albert M. Christy, in the circuit court, held that under the terms of the so-called territorial gross tax law, professional men such as certified public accountants, architects, engineers, surveyors and dentists are not subject to the higher tax rate of 1½% but are subject merely to the lower levy of one half of one per cent. This decision affected five test actions brought against the tax commissioner of the territory by a firm of accountants, an architect, a firm of surveyors, a civil engineer and a dentist. It is difficult to believe that any other decision could have been rendered, but it is of interest nevertheless to record that the decision supported the contention of representatives of five important groups of professional men.

Taxation—A Divertissement

One would scarcely expect to find any element of joy or amusement in hearings conducted by committees on such doleful subjects as tax bills, yet occasionally one who has the will and the ability to read between the lines can derive a serene delight from the very absurdity of the proposals made and the consideration accorded them. As an illustration of the difficulties which confront the makers of laws, it is interesting to consider the report of a committee appointed by Winston Churchill when he was chancellor of the exchequer of Great Britain. After eight years of work, the report, published on April 7th, concludes that "it is a vain hope to codify the income-tax law so that the layman can easily understand it." For example the committee discovers that the one word "assessment" is used in eight different senses in tax legislation. "The actual language in which many provisions are framed," the committee said, "is so intricate and obscure as to be frankly unintelligible. Probably no chapter in our legislation

has incurred more condemnation from the judiciary for drafting imperfections." Now if this be the sad state of affairs in Great Britain with its many years of experience and its really sincere efforts to draft and enact intelligible tax laws, how can we expect utter clarity in our own somewhat befuddled congress. The average American legislator is much more picturesque than his British fellow, but we must admit that for earnest and painstaking effort the representatives of the British people excel. And yet even they can not make a tax law so simple that he who reads may understand. For exemplification of the maze of confusion which bewilders our legislators, let us turn to the report of hearings on the revenue bill of 1936, where we shall find that it was seriously proposed, for the purpose of simplification, to present an algebraic formula as a basis for income-tax computations. Every reader of The Journal of Accountancy will see at once that providing the man in the street with an algebraic formula will make the preparation of income-tax returns an almost ecstatic delight. It will be so simple. We shall be able to do away with the old fashioned arithmetic, which no one understands any way, and deal with the matter with the aid of algebra, hand maid of the masses.

To Compute a Tax on Undistributed Income

The report of a subcommittee of the committee on ways and means dated March 26, 1936, proposed a tax on undistributed income of corporations and set forth proposed schedules for computation of a tax graduated according to percentage of corporate net income which was undistributed. The rate of tax proposed would be determinable after the undistributed net income was first known and the amount of the undistributed net income was determinable only after the amount of the tax had first been deducted. It has been suggested by certain malicious souls that in the schedules prepared for consideration of congress, a rather ingenious attempt is made to disguise extraordinarily heavy rates of taxation and to mislead the public into believing that the taxes proposed would not really be confiscatory. However that may be, the subcommittee's recommendations were as follows:

For the purpose of the schedules hereinafter recommended the term "adjusted net income" means the net income (see recommendation No. XV relating to intercorporate dividends) less the

credit allowed by section 26 of the revenue act of 1934 (relating to interest on liberty bonds and interest on obligations of government corporations).

The term "undistributed net income" means the adjusted net income minus the sum of:

(1) Taxable dividends paid during the period beginning on the expiration of 2½ months after the beginning of the taxable year and ending on the expiration of 2½ months after the close of the taxable year (see recommendations Nos. XI, XIII, XIV, and XVIII); and

(2) The tax computed under the schedules contained in this recommendation.

The schedules proposed are as follows:

Schedule I

CORPORATIONS WITH ADJUSTED NET INCOME OF $10,000 OR LESS

If there is no undistributed net income, there shall be no tax on the adjusted net income.

If the undistributed net income is 10% of the adjusted net income, the rate of tax on the adjusted net income shall be 1%.

If the undistributed net income is 20% of the adjusted net income, the rate of tax on the adjusted net income shall be 3½%.

If the undistributed net income is 30% of the adjusted net income, the rate of tax on the adjusted net income shall be 7½%.

If the undistributed net income is 40% of the adjusted net income, the rate of tax on the adjusted net income shall be 13%.

If the undistributed net income is 50% of the adjusted net income, the rate of tax on the adjusted net income shall be 18½%.

If the undistributed net income is 60% of the adjusted net income, the rate of tax on the adjusted net income shall be 24%.

If the undistributed net income is 70% of the adjusted net income, the rate of tax on the adjusted net income shall be 29½%.

If the undistributed net income is 70.3% of the adjusted net income, the rate of tax on the adjusted net income shall be 29.7%.

Schedule II

CORPORATIONS WITH ADJUSTED NET INCOMES OF MORE THAN $10,000

If there is no undistributed net income, there shall be no tax on the adjusted net income.

If the undistributed net income is 10% of the adjusted net income, the rate of tax on the adjusted net income shall be 4%.

If the undistributed net income is 20% of the adjusted net income, the rate of tax on the adjusted net income shall be 9%.

If the undistributed net income is 30% of the adjusted net income, the rate of tax on the adjusted net income shall be 15%.

If the undistributed net income is 40% of the adjusted net income, the rate of tax on the adjusted net income shall be 25%.

If the undistributed net income is 50% of the adjusted net income, the rate of tax on the adjusted net income shall be 35%.

If the undistributed net income is 57½% of the adjusted net income, the rate of tax on the adjusted net income shall be 42½%.

If the percentage which the undistributed net income is of the adjusted net income is not one of the percentages of the adjusted net income shown in schedule I or II, then the rate of tax shall be proportionate.

If the adjusted net income is more than $10,000 the tax, at the option of the corporation, shall, in lieu of being computed under schedule II, be computed by adding:

(1) A tax upon the adjusted net income computed under schedule I; and

(2) A tax upon the amount of the adjusted net income in excess of $10,000, at the rate in schedule II which would be applied if the tax were being computed solely under such schedule.

Simplification by Higher Mathematics

This scheme of assessing the tax was enough to terrify even the bravest heart. But at the hearing before the ways and means committee on April 7th it was stated that a formula had been prepared by the statistician or the experts and had been presented to the subcommittee, but was stricken out of its final report. Here is the formula:

If the percentage which the undistributed net income is of the adjusted net income is not one of the percentages of the adjusted net income shown in schedule I or II, then the rate of tax shall be proportionate, being interpolated by the straight-line method:

That is, by the formula

$$x = \left[\frac{a-b}{c-b} \text{ times } (e-d)\right] \text{plus } d$$

where

x = rate of tax on adjusted net income;
a = per cent. of undistributed net income to adjusted net income;
b = bracket percentage next smaller than "a";
c = bracket percentage next larger than "a";
d = rate of tax on bracket next smaller than "a"; and
e = rate of tax on bracket next larger than "a".

EXAMPLE

Adjusted net income	$10,000
Undistributed net income	2,200
(a) Percentage of undistributed net income to adjusted net income	22%
(b) Bracket percentage next smaller than 22%	20%

(c) Bracket percentage next larger than 22%..................	30%
(d) Rate of tax on bracket next smaller than 22%..............	3.5%
(e) Rate of tax on bracket next larger than 22%................	7.5%

(x) Rate of tax on adjusted net income equals

$$\left[\frac{22-20}{30-20}\text{ times }(7.5-3.5)\right]\text{ plus }3.5;\text{ equals }\left[\frac{2}{10}\text{ times }4\right]\text{plus }3.5;$$

equals..	4.3%
Tax = 4.3% of $10,000 = ...	$430

This formula, it will be observed, is applicable when the amount of the undistributed net income is first known. It does not apply in a situation where the amount of dividends is the known factor and the undistributed net income is undetermined. It may prove an interesting mathematical exercise for persons who like mathematics to expand the formula to include: f equals per cent. of dividends to adjusted net income; then making the proper substitution for a—it seems that a equals 100, minus f, minus x—develop the resulting formula for determining x. In ordinary times it would be impossible to believe that congress might enact a law which would require algebraic formulæ for determination of tax, but today—well, one never knows what a day may bring forth in the fertile fields on Capitol Hill. At any rate, the proposal lent an air of gayety and lightness to the proceedings. Perhaps that was the intent, so that when the real blow falls, we may better be able to withstand it and to smile.

Certifying the Background

A correspondent, who is a genuine searcher after the unusual and a collector of oddities, sends the following last paragraph of an auditor's comment upon the audit of a life-insurance company for the fiscal year ended December 31, 1935, and signed by a certified public accountant, "I regard —— Life Insurance Company as one of the soundest in the insurance field and also because it has a background of stability through every crisis of the past 29 years." This sort of thing is not what the word "certificate" is generally considered to mean. It is a comment which may be justified or may be quite unwarranted, but it certainly has no value. Who cares what the auditor thinks of the background of a company during crises of past years? The reader of the audit report probably knows those facts as well as the auditor. The ideal report of audit excludes all extraneous matter.

Confidential Relationships in the Professions

In the April issue of THE JOURNAL OF ACCOUNTANCY we commented upon an interesting case in which the surrogate of New York county decided that working papers of an accountant were not subject to disposition by will. In other words, they were the property of the accountant but could not pass to any other person without the consent of the client whose affairs were the subject of the working papers. After death it would, of course, be impossible to obtain such consent. Therefore, the duty of the accountant's heirs would be to retain the working papers while there was any possibility that they would be required to assist in the defense of any post-mortem litigation and thereafter to destroy them, thus keeping the sanctity of the confidential relationship between client and accountant. A subscriber who has been reading our comment sends us a clipping from the New York *Times*, dated January 1, 1935, from which we quote briefly: "Carrying out the ethics of his profession, Dr. Francis X. Dercum in his will, made public today, ordered burned the private case records of his patients, including those of Woodrow Wilson. Dr. Dercum, who died last April, had among his patients notable persons from many parts of the world. He considered the records so confidential that they should never be seen even by other physicians." This report is interesting to accountants as it indicates the sentiment of one who was a prominent member of another profession. The Hippocratic oath demands that the practitioner of medicine shall never reveal the secrets which come to him in the course of his medical practice. This confidential relationship has continued from the days of Hippocrates almost up to the present. Today, it is said that a few unworthy followers have at times indulged in a rather blatant publicity which conflicts with the principle of the oath. The case is analogous to that which was the subject of discussion in the April issue. In both cases the professional man was the custodian of absolutely personal information, which must never be made known without the consent of the patient or the client.

Imaginary Frontiers

The administrative branch of our national government seems to be endeavoring to draw a line where none exists—a line between capital and labor. There is an effort to set neighbor against neighbor, brother against brother, on some unfledged theory that there is a point at

which possession of goods or home or money becomes nefarious and, on the other hand, that there is a point at which the lack of these things becomes commendable. The haves and have-nots are called by the utterly insignificant names of "capital" and "labor." Now what is labor? There may be a glass partition between the shipping room where goods are packed and dispatched and the room where the order to ship is entered and passed out to the shipping department. At the other end of the floor may be another room where we find on the door in small gold letters, "Mr. Doe, President." Between these three simple classifications may be various grades of vice-presidents, secretaries, treasurers, upper-clerks, under-clerks and so on. Where in the congeries does labor become capital in the present political sense? Which is the sinner here and which the saint? Of course, there is no exact point of separation. Accountants know this, but the ordinary man in the street knows nothing about it, and he listens to the clap-trap with which the broadcast bands are burdened or he reads the propaganda with which the mails are flooded and, being a gullible person, he believes that this manufactured division of the people is a verity. It seems, therefore, that it is the duty of every one who knows the facts to expound them to the uninstructed, the guileless in the way. It is high time that people knew that there is no more definite a line between capital and labor than between rich and poor. Where do riches and poverty begin? Of course, the question is silly, but not a wit more silly than the current attempt to build a wall between the realms of capital and labor. The people do not understand. The distinction between employer and employed is not a measure always. Even there the line may be rather vague.

The Secret Society of Capital

In many a gathering of citizens lacking in practical experience or of a meager intelligence one may find whole-souled and honest belief in the existence of some esoteric order of society into which none but the initiate may enter. In that inner circle deeds of tragic wickedness are the unvarying order of the day. Nothing right or righteous can take place there. It is the source and center of all infamy. All this is nonsense; but the prevalence of the belief in it is not a laughing matter. The seeds of falsehood and sedition are being sown for immediate purposes, but the harvest will grow without tending. That sort of crop needs no culti-

vation. Further, the seeds grow in greatest luxuriance in the crowded shadows of the city. It should not be necessary—but, alas, it is—to remind Americans that theirs is a land where the people are supposed to rule and the tyrant's heel treadeth never on the neck even of the humblest. Our national anthems and some of our marching songs reveal a somewhat too exuberant protestation of our individual liberty and our right to do as we will. But the devil of it is that if an ogre is conjured up before the eyes of the credulous they tremble lest liberty has gone away and left them unprotected. Then they hate the spectre, although it may be entirely unsubstantial and fantastic. During recent years, we have watched a genie emerge from a weird sort of bottle and we have called this wonderful thing "capital." Many of us believe that there is such a thing in very life and that it roams about the earth seeking whom it may destroy. Countless books have been written, callow professors with collegiate degrees and no practical experience whatever declaim and roar about this chimera of capital, and it has become a part of our philosophy of living. Yet, as a matter of fact, everybody who owns the shirt he wears is a capitalist. He owns something. And, as most of us have a shirt to our backs, we are capitalists and therefore fellows in crime. Some of us may have more shirts than have others and there are degrees of haberdashery, but a shirt is a shirt and no one can deny it.

A Vile Imposition on the Credulous

All this legerdemain, this dragging of capitalists and other white rabbits out of hats is silly, but it is dangerous, nevertheless, because it imperils the lasting peace of the family, which, God knows, is much to be desired. He who arouses anger and unrest where these have never been before is a traitor and a menace, whether his foothold be soap box or legislative green carpet. Indeed the orator of the public parks is an honester man than the other, because generally he is an alien who has taken no oath to support and defend the constitution of the United States against all enemies, foreign and domestic. If only the people who deserve the name of American would band themselves together to search for the truth and to utter the truth without thought of party politics or the approach of election day, without being swayed by contemplation of all the many unhealthy excrescences on a republican form of government, it would not take long to lay the ghosts of class hatred and of the warfare, which so

far is purely vocal but may become actual. Every good American, Democrat or Republican, should be able to discern between the truth and the lie.

Deception for Political Effect

Labor, which is another fictitious giant, we suppose may be roughly described as the men and women who work for wages of some sort without a right to participate in profits arising from their work. That, of course, is not an accurate definition, because it would exclude labor which participates in a profit-sharing plan; but the definition will serve and its inadequacy merely emphasizes the impossibility of drawing a line at which labor becomes capital and capital labor. There is such a welter of malevolent propaganda attempting to set up a caste system that the public should take warning. Who better than the accountant and the engineer can set at nought the schemes of self-seeking politicians? Business has not been greatly deceived, but the employees of business have been led astray and the process of confusing the public mind by specious falsehood is spreading. Today there are probably a hundred men and young women who have learned to hate where yesterday there were not ten. What is much needed is an awakening of the public from a nightmare of fear and distrust. We are all Americans—some richer than others; some, alas, very poor—but few very poor or downtrodden because of the evil machinations of any person or group of persons in that romantic realm of capital. The demagogues who are stirring class hatred, if they have any knowledge at all, must know that they lie and that they are destroying the stability and faith of the country, but ever since the days when men first began to let their voices be heard by their gaping fellows, demagogues have been the same—until some one or perhaps a court of nine challenged the lie and the multitude caught a glimpse of truth.

Peculiarities of Our Federal Taxes

By Will-A. Clader

"We, the people of the United States, in order to form a more perfect union, establish justice, insure domestic tranquillity, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity, do ordain and establish this constitution for the United States of America." So said the forefathers.

To raise revenues with which to achieve the purposes of federal government, the constitution gave the congress power "to lay and collect taxes, imposts and excises."

The forefathers provided in the constitution that "direct taxes shall be apportioned among the several states, according to their respective numbers," as defined therein.

In 1862 and again in 1894 the congress passed a law authorizing the federal government to collect taxes on incomes. According to the supreme court the income tax employed during the civil war was not a direct tax, but it declared the 1894 act unconstitutional, as a direct tax without apportionment. A constitutional amendment was later ratified by the states, and on February 25, 1913, the sixteenth amendment became a part of the constitution, as article XVI, which reads: "The congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." The effective date of the first statute enacted thereunder was March 1, 1913. After this obstacle was thus hurdled, the court reached the conclusion that an income tax is not a direct tax.

Until income taxes were imposed by the revenue acts federal taxes did not reach into the personal affairs of the people, though in our early school days we read about the "whiskey rebellion" in the western part of Pennsylvania as a result of a federal excise tax.

Prior to the passage of the sixteenth amendment, the federal government was reasonably restrained in its expenditures. But shortly after this taxing privilege had been granted, free spending was inaugurated. The United States supreme court has said of the revenue acts that they reveal in their provisions an intention

to reach "pretty much every sort of income subject to the federal power."

The money spent by the federal government during the last fiscal year was raised as follows from:

Personal income taxes	7%
Corporation income taxes	8
Liquor taxes	6
Tobacco taxes	6
Processing taxes	7
Excise taxes	5
Custom duties	5
Estate and gift taxes	3
All other taxes, fees, etc.	4
	51
Borrowing	49
	100

In 1920 about sixty per cent. of the federal receipts came from direct taxes on profits and incomes. Today only about 28 per cent. comes from this source. The advocates of direct taxation claim that the indirect taxes which are wholly, or indirectly, hidden from the taxpayer are a painless form of tax extraction which has two effects. Not only do they lull the taxpayer into a sort of sleepy security, but they are a signal to the congress to go ahead with large expenditures. Advocates of direct taxation believe in taxation which is so framed that those who pay are aware of it. The advantage of indirect taxation to the taxpayer is that he pays as he goes. With the present system of income taxes he does not know until after the close of the year what his tax liability is.

The income-tax unit expects to handle this year 5,500,000 returns, of which more than 4,000,000 will be filed by individual taxpayers. Ninety per cent. of the individual returns will be made by persons who had a net income of less than $5,000, and of these more than two-thirds will be non-taxable. Only 6 per cent. of the 1934 income tax was collected from incomes under $5,000, although those incomes constituted 70 per cent. of the total income reported in returns. The British collect 40 per cent. of income taxes from incomes under $10,000. The largest group of Canadian income taxpayers in 1933 was made up of those who paid on incomes of less than $2,000.

The present system of income taxes is an outgrowth of the corporation excise tax act of 1909, which imposed a tax measured by the net income of corporations. Now people, as well as corporations, are taxed. It is a long way from the 1 per cent. rate of 1909 to the present rate of 15 per cent. on corporation net incomes over $40,000. The rates on individual incomes run from nothing to a rate of 75 per cent. on total net income.

The revenue act of 1935 is not, like its predecessors, a complete taxing act in itself. Some of its sections amend sections of the revenue act of 1934, some amend the revenue act of 1926 (which forms the basis of the present estate tax), some amend the revenue act of 1932 (gift tax and excise taxes), and a few, such as sections 105 and 106, imposing new taxes (the new capital stock and excise-profits taxes), supersede similar sections in the revenue act of 1932 instead of amending the old provisions.

The 1934 act took away the privilege of filing consolidated returns from all corporations except those which are common carriers by railroad and their related holding or leasing companies. There are, however, many unsettled cases under the acts prior to 1934, some of them under article 15 of regulations 75, which cover 1929 and subsequent years. This article stipulates the several liabilities of the members of an affiliated group included in a consolidated return. Paragraph (2) of the article reads, "Except as provided in paragraph (b), the parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed upon the consolidated net income of the group."

In the absence of the stated exception, it seems clear that each company included in a consolidated return is liable for the tax and for any deficiency later asserted, so let us read paragraph (b) to ascertain in what circumstances such liability does not apply.

"Liability of subsidiary after withdrawal. If a subsidiary by reason of a bona-fide sale of stock for fair value has ceased to be a member of the affiliated group, its liability under paragraph (a) shall remain unchanged, except that if such cessation occurred prior to the date upon which any such deficiency is assessed (other than by a jeopardy assessment), such deficiency in the case of such former subsidiary shall be reduced to an amount equal to such part as may be allocable to it upon the basis of the consolidated net income properly assignable to it. In no case, however, shall any demand for the payment of any deficiency be made, or

any distraint or proceeding in court for the collection thereof be begun, against such former subsidiary prior to the determination by the commissioner that the amount of the deficiency can not be collected from the parent corporation and the corporations (if any) remaining members of the affiliated group."

Taxpayers have contended that if affiliation ceased prior to the date upon which a deficiency was assessed the former subsidiaries were liable only for such part thereof as was allocable to them upon the basis of the income assignable to them.

The bureau has contended that the parenthetical expression "other than by a jeopardy assessment" was for the purpose of collecting such deficiency in full from any of the former subsidiaries if the former parent and the remaining corporations were unable to pay.

If the bureau is correct in its construction of the regulations that a former member of an affiliated group can be held liable for the entire amount of a deficiency assessed after the parent has sold the stock to another company, just by issuing a jeopardy assessment, it seems to me the author of the regulations would have stopped with (a) of paragraph (b) which provides that the liability of each subsidiary for a deficiency shall remain unchanged after affiliation ceases; or he could have stopped with paragraph (a) with no mention of an exception.

In one case a parent, during the year, sold its holdings in a subsidiary which was also a parent of a group of affiliates, and the cash from the sale entered the treasury in place of the stock sold. Shortly after this severance of affiliation, the former parent purchased the stock of another subsidiary and later sold it at a profit, these transactions occurring in the same year. The tax on the resultant income was duly paid.

Before a deficiency was asserted, the parent company became insolvent. Later a deficiency was asserted and a jeopardy assessment made upon the former parent and upon each of the former affiliated group. The subject of the deficiency was the profit made on the transactions after cessation of affiliation with the group of former subsidiaries, to which such subsidiaries in no wise contributed.

Unfortunately, neither the bureau nor the taxpayers seem to desire to run the risk of a test and the deficiency was compromised and the former subsidiaries paid. If the bureau is correct in its position, no buyer of the stock of a company in

an affiliated group, particularly at any time in a taxable year other than on its last day, could afford to assume unknown liability, through his stock ownership, for income tax of the seller on transactions after the affiliation ceased.

Before any income can be freed from taxation by means of deductions there must be an applicable statute to permit it. (*New Colonial Co.* v. *Helvering*, 292 U. S. 435, CCH 9048.) The expenses to be deductible must be incurred in doing the ordinary and necessary things the taxpayer's business requires to be done to make it function as such. (*Motion Picture Capital Corp.* v. *Commissioner*, CCA, Jan. 6, 1936, CCH 9048.) Examining officers are disallowing deductions to a greater degree today than ever before, on the ground that they are not "ordinary and necessary" expenses incident to the conduct of the business.

A taxpayer who keeps his accounts on the accrual basis must ascertain when a state tax accrues as a liability in order to know in what year he may deduct it in his return. It is possible for a tax to be payable in and applicable to a year subsequent to that in which it is deductible.

The federal capital-stock tax is deductible in the year in which it accrues, and the bureau ruled that the tax for the year ended June 30, 1934, as imposed by the 1932 act, although it was repealed by the 1934 act and not paid, accrued on July 1, 1933, and was deductible in 1933. Examining officers adjusted returns accordingly.

Treasury decision 4422 caused considerable concern to corporate taxpayers when it was issued. In the administration of this ruling, respecting depreciation deducted in a return, the bureau has shown a lenient attitude if the taxpayer submits full information, though not in the form specified in TD 4422. My experience, however, is that a depreciation schedule compiled in compliance with the requirements of the bureau is helpful to the taxpayer in accounting for fixed capital and depreciation thereof, aside from its relation to taxes.

The regulations provide that losses claimed on the normal retirement of depreciable assets included in groups of items, when depreciation is based upon the average life of such assets, are not allowable but shall be charged to the depreciation reserve account. If there is no change by the bureau, depreciation thus computed in accordance with TD 4422 will enable the full cost of the property to be recovered.

When property is disposed of by causes other than normal, the loss is deductible in the current year, subject to the limitations provided in the act upon deductions for losses, but the limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets. It will be to the immediate benefit of taxpayers to be able to show that retirements are not normal, if that is the case.

It is a bad law that makes waste profitable. The capital-loss limitation can make it desirable to destroy instead of to save. A building costing $15,000 (net of accrued depreciation) could be sold by a corporation to some one who could use the lumber for $1,000. The loss would be $14,000, but only $2,000 thereof could be claimed as a loss in the tax return (in the event of no capital gain) reducing the tax $300. It would be more economical to burn the building, take the abandonment as a complete loss and reduce the tax by $2,250, resulting in a saving of $950. On the other hand, by a mere bookkeeping device the sale could be effected and the full loss taken. The taxpayer could write down the property on the books to the salvage value, as required by the present regulations (Art. 23 (e)-3), and show by his records that the asset was determined to be practically worthless. He could sell it later for the salvage value, as junk, showing two transactions, though they may occur in the same year or even almost simultaneously. It is to be expected that the bureau would not consider this a "sale or exchange" on which the capital-loss limitation would be applied. Certainly it should not do so.

Title to property must cease before loss is allowable. Abandonment alone may not void title. The taxpayer familiar with the regulations will be able to show by his records that the sale is not a commercial one but is a mere disposal arrangement. The deciding factors are cessation of usefulness of the asset and the record of write-down. An ignorant taxpayer would probably be taxed, as ignorance of the law is no defense. The bureau will not reframe the transaction for him.

This brings up the question of tax avoidance. It is not improper for the primary motive in carrying out an arrangement to be tax avoidance. Justice Sutherland, in a recent opinion, held "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, can not be doubted." But who

wants to be compelled to go to the supreme court to clear him of fraud charges? "Intent to evade tax" or wilfully to defeat the tax is a crime. However, a taxpayer who deliberately made a fraudulent return, which would not have resulted in a tax if correctly prepared, is not punishable. I know of a return containing wilful misstatements which were made because the taxpayer ignorantly thought it sustained a taxable net income. When the corporation changed owners a deficiency notice was received, and it was discovered that legal deductions to which it was entitled had not been taken. No tax resulted, and the guilty treasurer was never even accused of the fraud which he thought he perpetrated.

There is an old supreme court decision which enunciated the oft-quoted principle that ". . . . if a device is carried out by means of legal forms, it is subject to no legal censure." But we frequently see decisions resting on the substance and not the form. Only recently the circuit court of appeals, fourth circuit, stated: "Such admitted facts plainly constitute a plan—not to use the harsher terms of scheme, artifice or conspiracy—to evade the payment of the tax. . . . The sale of the stock in question was, in substance, made by the respondent company, through the stockholders as agents . . ." (CB XV-1, p. 11).

The bureau will not recognize gain or loss from the trading in of automobiles for business purposes, together with cash for new automobiles to be used for like purposes, apparently relying upon section 112 (b) (1) of the act. The regulations state: "No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck, or a passenger automobile for a new passenger automobile to be used for a like purpose."

In corporate accounting covering cost of automobile operations, the annual depreciation in the year in which an automobile is "traded-in" is adjusted up or down to reconcile the depreciated cost to the "trade-in" allowance. This is the practical and equitable method.

The bureau has refused to allow this sensible accounting to be used in income-tax deductions for automobile expenses. In addition to applying an arbitrary rate of annual depreciation, and ignoring the taxpayer's actual experience in automobile useful life, the bureau will add to the cost of the new car the undepreciated

amount of the old. Thus, if a taxpayer followed the bureau's rule, he would find his automobile equipment account reflecting a ridiculous and absolutely incorrect condition:

Cost of old automobile		$2,100.00
Less depreciation for two years allowed by bureau at 20% a year, on a five-year life expectancy		840.00
Depreciated value		$1,260.00
Cost of new car	$2,500.00	
Less allowance on old car (traded in)	690.00	
Cash paid for new car		1,810.00
New car—the actual market value of which is $2,500		$3,070.00

This car would, therefore, be on the books at $570 in excess of its actual purchase price. The excess of course is the loss on the old car.

On the other hand let us suppose that the corporation depreciated the car, according to its life-experience table which is, say, three years; therefore, the depreciated value on the books was $700. It adjusted the annual depreciation by the difference of $10 between the books and the trade-in value and recorded the new car at its actual cost of $2,500. To complicate the matter further, the depreciation had been charged on the books to a clearing account, "automobile expenses," and the entire expenses were apportioned on the basis of the purposes for which the automobiles were used. Many of the property accounts were charged with a portion of the automobile expenses, so it is readily seen that it would be difficult to unscramble the depreciation included in the charges and adjust the return. If the bureau allowed the depreciation on the basis of the taxpayer's accounting system consistently maintained, the government would lose nothing in the end.

The importance of calculating the depreciation deduction as accurately as possible and claiming in the return the amount "allowable" is brought to attention by a recent bureau ruling. (XIV-50-7853, IT 2944, p. 4). The bureau was asked whether the depreciation claimed on an income-tax return which had been accepted by the bureau constituted depreciation "allowed" for the purpose of adjusting the basis to be used in computing gain or

loss, depreciation exhaustion or obsolescence in subsequent years controlled by the revenue acts of 1932 and 1934.

Sections 113 (b) and 114 (a) of the revenue acts of 1932 and 1934 in effect provide that the basis for such purposes shall be adjusted for exhaustion, wear and tear and obsolescence to the extent allowed (but not less than the amount allowable) for any period since February 28, 1913. It was held that the word "allowable" designates the amount permitted or granted by the statutes, as distinguished from the word "allowed" which refers to the deduction actually permitted or granted by the bureau. The amount "allowable" is the minimum for adjustment purposes; the amount "allowed" serves to measure the adjustment only when the amount exceeds what is allowable.

Depreciation claimed as a deduction in a return which has been accepted by the bureau is the amount "allowed" for that year. The amount thus allowed for any year may be adjusted to the amount "allowable" at any time within the statutory period applicable thereto for purposes of computing the proper deduction for such year and of adjusting the basis. The statute, however, requires adjustment of the basis to accord with the amount "allowed" or the amount "allowable," whichever is greater, irrespective of any statute of limitations applicable to the year of deduction.

Capital gains and losses of individual taxpayers are now subject to certain allowances for the length of time the assets were held, calculated at prescribed percentages of gains or losses. The deductible capital loss is limited to $2,000, plus so much of the capital gains as must be included in gross income. Thus if one sold in 1935 capital assets which resulted in taxable profit of $6,000 and had a recognized capital loss of $8,000, he would report $6,000 as income and deduct the sum of $6,000 and the $2,000 allowable losses, or $8,000. If the net profit was $6,000 and the recognized loss was $24,000, the deduction would be $8,000, and the taxpayer would get no benefit, in any return, of $16,000 of his excess of $18,000 of 1935 capital losses over his 1935 capital gains.

The graduated percentage of reduction of capital gains and losses does not apply to corporations, but capital losses sustained by corporations are deductible only to the extent of $2,000 plus the taxable gains.

In December last, some brokers informed their clients that stocks on which profits were taken could be repurchased immedi-

ately. In that way a higher basis for a subsequent sale would be established. For example, suppose one had a capital loss of $3,000 and had no profits from the sale of capital assets—the law permits him to deduct only $2,000, and he loses the benefit of $1,000 of the loss. One owns stock costing $15,000, which he can sell for $16,000. He therefore sells the stock and reports a gain of $1,000 against which he can deduct the aforesaid loss of $1,000. He buys back at $16,000 the stock he sold, which increases the cost he may use when he eventually sells such stock. This is supposed to be desirable in a rising market: (a) to offset capital losses otherwise unavailable, or (b) to apportion profit between two years and thus keep the surtax down in the lower brackets. Such transactions have not yet come under the scrutiny of the bureau.

The question always is whether the transaction under consideration is in fact what it appears to be in form. In the *Gregory* case, it was held that the intent or purpose (the substance) controlled even though the form was observed. There "what was done" was to comply literally with the terms of the statute. The court gave attention to "what the parties intended to do." Upon ascertaining that the parties did not effect the transactions intending to accomplish normal business purposes the court concluded that the prescription of the statute was not satisfied.

There has not been any clear standard for the application of the general rule of "form" and "substance," though there has been a fairly consistent recognition of the general rule. The rule as stated is that mere forms have no significance, but the substance of the transaction must control. It is also consistently recognized that legal forms are in themselves things of substance which can not be disregarded if actually employed in good faith. The distinction is between a mere artifice or subterfuge, which does not represent an actual legal transaction, and a formal act.

The act of 1935 provides that no gain or loss shall be recognized in a taxable year beginning after December 31, 1935, upon receipt by a corporation of property other than money distributed in liquidation, begun after August 30, 1935, if the corporation receiving such property was on August 30, 1935, and has continued to be at all times until the liquidation in control of the other corporation. If the controlling corporation receives property and money, the gain, if any, will be recognized to an amount not in excess of the money received, but no loss from such an exchange will be recognized.

The 1935 act changed the rates on corporate earnings for taxable years beginning after December 31, 1935. Thus a corporation whose taxable year began December 1, 1935, would be taxed at the old rate of 13¾ per cent.

The social-security act imposes a federal tax that goes all the way down to the bottom of the economic scale, taking toll from persons who work for wages, no matter how low. It is an excise tax on employers computed on the size of the payroll—a payroll tax and a pay envelope tax. There are, in fact, two different payroll taxes on employers, (a) the unemployment compensation tax and (b) the old age benefit tax. The third tax is an income tax on all wage earners levied directly on their pay envelopes, for old age benefits.

The unemployment compensation tax begins with 1 per cent. of the payroll and began to accrue January 1, 1936. It will be 2 per cent. for 1937 and 3 per cent. for 1938 and thereafter. The old-age-benefit tax on employers begins at 1 per cent. for 1937, then rises by triennial jumps of ½ per cent. until it, too, reaches its 3 per cent. maximum in 1949. Then and thereafter employers will pay 6 per cent. of their payroll in excise taxes for social security. This includes tax on the salaries of the highest executives. A social-security act for the benefit of employers seems not in the offing.

The tax on the pay envelopes of wage earners is to be deducted from the wage or salary every pay day. The rate is the same as the tax levied on employers. It applies to wages or salaries below $3,000 a year.

A case decided February 10, 1936, in the district court of the United States for the western district of Kentucky is attracting wide attention.

The court held that an erroneous declaration of value on an original capital-stock tax return for 1933 could be corrected by an amended return if filed before an excess-profits tax return is due. It held further that the value of the capital stock declared in the original return (which was its book value) was so understated as to constitute no declaration of value in fact. (*Oertel* v. *Collector.*) This decision will, I believe, have a far reaching effect in future tax litigation. I quote from it for the information of those who have not read it.

The collector contended that the declaration of value in the first return can not be subsequently amended; therefore a mistake, if made, can not be corrected.

The taxpayer contended that the act does not permit an arbitrary declaration of value by him, and if the declared value in the original return is untrue, it may be corrected.

The court said:

"To justify a tax, the necessary basis of fact must exist to invoke the taxing power to impose it. The congress can make law apply to the facts; it can not make facts apply to the law, nor can it delegate power to a taxpayer to do so. Many things are immutable and one is a fact; there is no power to change it. Disputes often arise as to what constitutes a fact, but the truth itself is indisputable.

"The act here in question measures the tax according to the value of the capital stock of the corporation. The taxpayer is authorized under the provisions of the act to declare the value, but this can not be arbitrarily done; there must be a basis in fact for its conclusion. If the act authorized an arbitrary determination, it would be void for uncertainty. A statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the fifth amendment.

"If the above statute is construed as contended by the defendant, that the taxpayer can fix and declare the value of its capital stock regardless of underlying facts, it is void. If 'value' as used in the act is given its ordinary and accepted meaning in the sense there used, it is a valid exercise of taxing power. . . .

"A naked valuation is an anomaly in tax law. . . .

"If the act here in question is construed to raise a conclusive presumption that the tax is to be levied on the declared value of the taxpayer, regardless of the actual value, it is violative of the fifth amendment."

The court gave an illuminating explanation of what is value. I believe we may reasonably expect to see this decision quoted in any tax case in which value is a factor.

Some of the changes in the revenue act that have been suggested recently (before taxes have been collected under the 1935 act) are: discard all federal corporation taxes under the present tax laws (including the capital-stock and excess-profits tax under the 1935 act); enact graduated taxes on undistributed corporate earnings; increase tax on corporate dividends received by individual taxpayers, by removal of the section in present tax laws which exempts corporate dividends from the 4 per cent. normal tax; enact legal processing taxes.

Earned surplus as used in corporate accounting is a balance-sheet account to measure the excess of the assets over the liabili-

ties and capital contributions. It is the difference, of course, too, between the sale of products or service and the cost of producing and selling the product or rendering the service.

The idea of the proposed tax on corporate earned surpluses is to force corporations by a penalty tax on surpluses to pass on to stockholders all their earnings so that the stockholders can be taxed for these profits as personal income. This plan can not be intended only to prevent the piling up of surpluses beyond prudent requirements, because there is already imposed in the revenue act a surtax in the nature of a "penalty" upon any corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation (a parent corporation, for example) through the medium of permitting gains and profits to accumulate instead of being divided or distributed." The rate is 25 per cent. of the amount of the adjusted net income not in excess of $100,000, plus 35 per cent. of the amount of the adjusted net income in excess of $100,000. At present, though, where the major portion of the assets represented by the surplus are used in the business, such as land and buildings, that fact would tend to show that the corporation was not availed of for the purpose of surtax evasion by its stockholders. The present law is not intended to prevent reasonable accumulations of surplus for the needs of the business.

Further a special surtax is imposed upon the undistributed adjusted net income of personal holding companies as defined in the statute.

At the present time corporate earnings are heavily taxed. With surtax rates on individuals as high as 75 per cent. and 15 per cent. on corporate net income over $40,000, they may be taxed at approximately 82.75 per cent. A stockholder with a net income of $3,400 all from dividends, though free from any income tax on his personal return, may have paid 15 per cent. income tax on $4,000, or $600, through his corporation, while a taxpayer with $3,400 income from sources other than dividends would in no instance pay more than $82.40, or 2.4 per cent. This gross inequality seems unjust and probably it is in some instances. The only way it could be overcome would be to free the corporation from any income tax at all and to tax the stockholders on their interest in the earnings; but because the tax on individual incomes is not at a fixed per cent. but at increasing percentages for various parts of the income, the complexities are prohibitive, so this suggestion could not be

adopted. Before the din of the discussion in Washington is quieted we may find ourselves returning to an excess-profits tax on corporations, similar to that with which we labored during and immediately after the world war.

There are decisions of the supreme court holding that where the power to tax is conceded, the motive for the exaction may not be questioned. (*U. S.* v. *Constantine*, Dec. 9, 1935, XIV CB 52, p. 26.) It is for us, therefore, to consider only the effect the suggested change in taxes on corporations would have on business.

"When the requirements of income-tax law run contra to, or are inconsistent with, a corporation's existing obligations to its creditors, they violate sound fiscal principles." Thus a writer in the New York *Times* (March 22, 1936), calls attention to how the proposed tax upon undistributed earnings could impose conditions which would prevent a corporation from complying with its previously made covenants in its bond issue.

Bond indentures frequently require that, in addition to a fixed sinking fund, an additional sinking fund shall be erected, based upon available earnings calculated in accordance with a prescribed formula. The practical effect often is that dividends can not be paid upon capital stock of the issuing corporation until the bonds are retired. Some indentures require the maintenance of specified ratios of the amount of liquid assets to the liabilities, in the absence of which dividends shall not be paid.

I can not believe that our government of the people is going to say to the people, "Default on your contractual obligations to your creditors; distribute your earnings to the stockholders; do not pay your debts; otherwise we will levy a penalty tax upon you for failure to do an act made illegal by terms of the indenture of bond."

Definiteness of meaning is given to the revenue acts by treasury regulations. So we would like to believe. The increasing number of cases appealed to the board and the courts, however, must indicate that the meaning has been a matter of conjecture by lawyers and judges since the enactment of revenue acts.

In the interpretation of taxing statutes, a doubt is generally resolved in favor of the taxpayer and against the government, particularly where the doubt involves the meaning of words. But the examining officers of the income-tax unit of the bureau of internal revenue decide most doubts in favor of the government, probably because they know the taxpayer can go to the

internal revenue agent in charge, the income-tax unit in Washington, the technical staff of the bureau, the board of tax appeals, the circuit court of appeals, and finally to the United States supreme court.

A general feeling prevails that it is useless and a waste of time to appear before the internal revenue agent in charge in protest to an asserted additional income-tax liability. Experience often indicates that this feeling is justified, for too frequently in the face of conclusive evidence that the examining office erred in his findings, often assumptive, the case is forwarded to the income-tax unit in Washington without change. Then the matters involved have to be discussed all over again. Some taxpayers believe that the best body with which to settle cases is the technical staff.

The technical staff has been called the "Hard bargain section." It drives the hardest possible bargain with the taxpayer. The former special advisory committee seemed to be actuated by a desire to settle cases correctly, and it settled a great many of them. Now if a taxpayer does not want to pay a large portion of the tax that is claimed, the case must be taken to the board.

The burden of proof is upon the taxpayer. In a case before the board which would result in a refund if the taxpayer's contentions were sustained, counsel for the commissioner refused to acknowledge that the tax had been paid. Fortunately taxpayer's counsel had the cancelled cheque with him, so did not lose his case.

The act provides that "the commissioner may grant a reasonable extension of time for filing returns" but that "no such extension shall be for more than six months." The authority is delegated to the collectors of internal revenue. Some collectors were reluctant this year to grant extensions, and in some sections of the country they refused to do so. It seems to be appropriate here to call attention to the efforts of the American Institute of Accountants to encourage business to adopt a natural business year. The adoption by business of such an accounting period would relieve the bureau of the present congestion at March 15th, and it would enable business to receive from public accountants prior to filing the return a more thorough consideration of tax problems than is now possible. In this movement the accounting officers of corporations can be of major assistance.

With transactions under the early revenue acts still the subject of pending legislation, any one who tries to explain federal taxes

is like an explorer of a labyrinth. Such a venturesome person gets lost among the side paths and blind passages with which the subject abounds.

Our government is of the *people*, for the *people* and by the *people*. Federal taxes are imposed by laws enacted by the representatives of the people. We must pay them, probably in larger amounts in the future than in the past to provide cost of government, which is about one-third of the total income of the nation—that is, we all work for four months of each year for the government, without pay. May we have the courage and the wisdom to insist upon reduction in cost of government and a consequent reduction in taxes, for reduction in cost of government and a consequent reduction in taxes will increase real wages. We can not believe in high taxation and a high standard of living at the same time. Government must tax the citizen, but it must not rob him. Chief Justice Marshall long ago pointed out that "the power to tax is the power to destroy."

Primary Accounting Concepts

A SPECULATION IN THE INTEREST OF CLARITY

By Lewis A. Carman

There is in accountancy a curious absence of any pronounced tendency toward research and scientific development. Unlike the medical and engineering professions, where laboratory work frequently precedes the practical application, accountancy has been shaped almost entirely by outward circumstances. Accounting thought has lain dormant for generations at a time, arousing itself sluggishly for self-improvement only after it has been kicked awake.

It is scarcely too much to say that in scientific development accountancy is not far beyond the empty profundities of the medical profession of a few centuries ago, with its four humors, blood, phlegm, choler and melancholy, or greatly in advance of the limited concepts of the ancients with their four elements, earth, water, air and fire. The basic concepts of accounting have never been completely unfolded and presented as a consistent system. It has been said—and I think truly—that no one has yet framed an adequate definition of the terms "debit" and "credit."

The confusion of today is made worse confounded by a frontal collision between two schools of accounting thought, each heaving large sections of the pavé at the other without much regard for the by-stander or for the wheels of progress. For want of better terms the two schools may be called the legalistic and the die-hard schools.

To the legalistic school the law is the fount of all knowledge. In particular, the belief is held that inasmuch as the corporation is the creature of the law the accounting for its operations is solely a function of the law. Personal opinion contrary to statute has no standing in court and, therefore, has none in fact. The die-hard school derives its conclusions from certain tenets imparted to it by its forefathers (perhaps on their death-beds) and regards a law contrary to these much as a chemist would regard a law "altering" the composition of water. (The *Atlantic Monthly* for July, 1935, cites an act of the Indiana legislature changing the ratio of the circumference of a circle to its diameter from 3.14159265 . . . to something more convenient.)

Much of the difference of opinion between the schools centers about the presentation of the capital structure in accounting statements, particularly that which is called "surplus." Shall this be a figure obtained by the application of a statutory formula or shall it be an amount equivalent to the excess of earnings over dividends? Both schools may lay down their brickbats, for their dispute lies in their failure to discriminate between different aspects of the same thing.

In explaining what this "same thing" is, I shall need a number of new terms which I must state and define as I go along. To begin with, we lack an acceptable term for the financial magnitude of a business entity. We can speak of the length of a pipe, the area of a field, the volume of a tank, the weight of a truck, the temperature of a room, and so on. For all these magnitudes we have units of measurement, feet, acres, gallons, pounds, and degrees. In accountancy we have the unit of measurement, the dollar (or other monetary unit), but we do not have a proper term for the financial magnitude measured by it.

The words customarily used—"capital" and "net worth"—must be rejected. "Capital," from the Latin caput, head, is a sadly overworked word. We speak of capital letters, capital cities, the capital of a column, capital punishment, a capital time, an investment of capital, the conflict of capital and labor, and so on. Even in the narrower limits of our profession the word has a variety of meanings, for we have capital expenditures, capital stock, capital surplus, stated capital and many others. The connotations of the word are so many and so ambiguous that it can not be used in any really scientific development of accounting concepts. It will here be employed only in the sense of wealth, money, etc. "Net worth" is objectionable because it is a phrase and not a single word, and because to many accountants "worth" implies current market value.

What we need is a word for the sum of the positive and negative values in a business entity or, in other words, the excess of asset values over liabilities. When I say values I mean simply the figures shown in the balance-sheet. These may represent values to which we heartily subscribe, values that are suspect and values that are qualified as untenable. Good, bad or indifferently exact, figures are the bricks without which balance-sheets can not be constructed. The term we seek, then, is simply the algebraic sum of the positive and negative values displayed in any given

balance-sheet. It is obtained by a mathematical process and no representation other than that of clerical accuracy is made for it.

It is difficult to select or to coin a word that will strike the ear aright, but I must have one before I can go on. With some diffidence I submit the word "quantum" from the Latin quantus (how much?), the root of our word "quantity." The trouble with "quantum" is that it sounds like something tangible that can be taken out of the safe and looked at, whereas it is an abstraction like length, area, weight, etc. I should like a word expressing better the idea of a sum or total. The Latin summa valorum (sum of the values) expresses the idea exactly, but it is hardly acceptable. Some concoction like "valusum" from value-sum, "totoval" from total-value, or even "capitotal" might be better if it did not grate so harshly on the ear. Undoubtedly a term similar to "magnitude" or "amplitude" (might we say "valitude?") would give better the idea of an abstraction, and I very nearly did select "amplitude." The word itself is not so important as long as it is clearly understood; and for our purposes "quantum" will have to serve.

The quantum, then, is defined simply as the sum of the positive and negative values (assets and liabilities) of a business entity, whether it be a corporation, partnership or sole proprietorship. We can then say that the length of this pipe is so many feet, the area of this field so many acres, the volume of this tank so many gallons and the quantum of this business is so many dollars. Quantum is a word for financial magnitude corresponding in use and meaning to those of physical magnitude with which we are already familiar. It should be emphasized that it is an abstraction, like all such terms, and not something concrete or tangible. When a piece is cut from a pipe, the length is decreased but not taken away. When a river overflows its banks and carries away the corner of a field, soil goes down stream but not area, which is merely reduced. A cash dividend, then, will reduce the quantum but is not "paid out" of it.

You must forgive me the time I have devoted to the selection and definition of this word, but it is essential to an understanding of what I am about to present, for, generally speaking, all accounting is the expression of one or more aspects of the quantum! What is meant by aspect? Suppose that we were making a sociological survey of a city of 100,000 inhabitants. We might classify the population by age, sex, race, nationality, marital

status, religious affiliations, political affiliations, property holdings, income levels, and so on. Each of these analyses could be submitted in the form of a summary whose total was 100,000, and each would present a different aspect of the same thing, the population (or magnitude) of the city.

Similarly, in accounting we seek to present certain fundamental aspects of the quantum (or financial magnitude) of a business entity. What are the principal aspects of the quantum? They are four, and may be mnemonically termed the "what" aspect, the "whence" aspect, the "whether" aspect and the "who" aspect, for of the quantum at any given date there may be asked these four questions:

1. By what is the quantum represented?
   This is answered by a statement of positive and negative items—or of assets and liabilities.
2. Whence came the quantum?
   This is answered by a statement displaying the positive and negative increments of value during the life of the enterprise—or a list of origins and dispositions of value. This is a statement now wanting in accountancy.
3. Whether and (if so) to what extent may the quantum legally be reduced by withdrawals?
   This is answered by a statement applying to factual elements whatever statutory formula is established as the measure of the amount that may be distributed.
4. Who owns how much of the quantum?
   This is answered by a statement of the rights, preferences and equities of each class of proprietors.

These four fundamental statements may be supplemented by two subordinate statements showing how the assets and liabilities and how the origins and dispositions varied during a given period (usually a year).

At present it is not unusual to see attempts made to present all four of these primary aspects in a single statement, with results that are little short of ludicrous. Now the commingling of unlike elements is the cardinal sin of every classificatory science, and accounting leans heavily on logical classification. Suppose, then, that in the interest of consistency we were to enunciate the following basic theorem:

One, and only one, aspect of the quantum may be presented in any accounting statement.

There is no catch in such a theorem. We recognize a similar postulate every time we draw up a chart of accounts. We fail to be consistent, however, when we present our accounting statements. What would be the form of our statements were we to enlarge our notion of consistency to include the above theorem?

It is not feasible to present here a full set of accounting statements, but the salient peculiarities of such a set may be fully described. If we denote the four fundamental exhibits by letters and the two subordinate statements by numbers, we shall have the following group that answers the questions posed above:

A. Statement of assets and liabilities (balance-sheet)
 1. Statement of value movements (flow sheet)
B. Statement of value origins and dispositions
 2. Statement of income and other increment
C. Statement of statutory corpus and surplus
D. Statement of corporate structure and owners' equities.

In these statements the inner workings of a business are displayed much as are those of a frog on a dissecting board. Now whether or not such a state of openness is the best of all possible states for a frog is a matter for argument—much depends upon whether one adopts the viewpoint of the frog or of the interested observer. And, similarly, it does not follow that the statements here outlined are the best of all possible statements in all circumstances, but they will (it is hoped) serve to clarify the primary accounting concepts in the mind of the observer.

The relation of these statements to the central concept of the quantum and to one another is displayed in the accompanying diagram. The statements are described individually in the following:

Exhibit A

The "what" aspect of the quantum is presented in exhibit A, the statement of assets and liabilities or balance-sheet. Such a statement is no more nor less than a list of the positive and negative values whose sum is by definition the quantum. It does not differ in any respect from the conventional balance-sheet in the presentation of the assets and liabilities. The one and only difference lies in the presentation of the sum of the values. This is presented logically as a single amount and is not broken up into a number of sub-items as is now the common practice. A com-

parative balance-sheet, for example, would have directly following the liability items a caption such as this:

	December 31.		
	1935	1934	Increase
Quantum (sum of the values)........	$1,381,642	$1,299,431	$82,211

But where, one may ask, are our old friends "capital stock," "surplus," and possibly other related accounts? Are not these essential items shown on your balance-sheet? How can you tell whether the business entity is a corporation, a partnership or a sole proprietorship?

The answer is simple. One, and only one, aspect of the quantum is presented in the balance-sheet and that is the "what" aspect. The sources from which values were derived, the amount that may legally be distributed in dividends and the relations with the proprietors are all aspects foreign to this statement and will be presented where logically they belong. Much of the lack of clarity in our accounting thought of today may be attributed to this confusion of categories. When we encounter "preferred stock," "common stock," "capital surplus," "earned surplus," etc., on a balance-sheet, we find a disordered and abortive attempt to present conjunctively concepts that are logically distinct.

The fact that the balance-sheets of corporations, partnerships, and sole proprietorships will all have the same appearance under our theorem is logically as it should be, for the essential differences between these lie solely in the proprietorship relation and should not have the slightest effect on a statement of constituent elements, or of "what" aspects. A statement of assets and liabilities is (as its name implies) essentially an inventory. A ton of pig iron is a ton of pig iron on any balance-sheet, cash is cash anywhere, an account receivable is an account receivable, a building is a building, and so on. The possessions of a business entity and the amounts owed by it are attributes entirely independent of the ownership form. They are elemental facts of the business considered solely as an operating unit. A truck, for example, may be owned by a corporation, a partnership or a one-legged Chinaman without affecting in any manner its characteristics as an operating unit. In any of these three cases, the make, the cost, the depreciation, the weight, the state of the engine, brakes and tires, the maximum load, the miles-per-gallon, the speed, the horse-power,

and so on, are properties of the truck completely independent of the ownership aspects. Similarly, a statement of assets and liabilities of a business entity should logically present only the "what" attributes common to any operating unit and these are the positive and negative values that constitute its magnitude—or quantum. Proprietorship relations are quite beyond the scope of such a statement and are logically presented as a separate aspect.

As the quantum is defined as the algebraic sum of the positive and negative values displayed in the balance-sheet, it follows that all possible light should be thrown on these values. The balance-sheet should furnish, either by direct statement or by unambiguous implication, the basis of valuation of each item (cost, market, appraisal, realization, etc.) and should be supplemented by comments that will enable a reader to form his own conclusions. The comments should show the composition, age and maturity of the receivables, the nature of the investments, the general characteristics of the inventories, the rates of depreciation and the reserves applicable to each asset, and so on. An ideal balance-sheet would show these details on its face, but too much detail tends to obscure general relationships and for that reason must be relegated to the comments.

Balance-sheets frequently display the assets and liabilities at the end of two successive years, with a comparison. Of course, such a statement may show the assets and liabilities at a single date or at as many dates as may be desired. A complete analysis might call for balance-sheets at intervals of not less than a year, commencing with the inception of the business.

Statement 1

Statement 1 is an exhibit designed to show "how" the assets and liabilities changed during a given period. When this statement supplements and supports a comparative balance-sheet it will show the details of the amounts in the "increase-decrease" column. It will do more than this, however, for it is in effect a journalization of the transactions for the period and as such affords a bird's-eye view of the value movements.

It is difficult to present such a statement in a small compass, for it must be confessed that the great drawback of the statement is its unwieldy size. It usually requires from ten to twenty columns for a proper presentation of the value movements. The following is an extremely condensed outline of such a statement

wherein the letters "d" (debit) and "c" (credit) are used in place of black and red figures:

	Incoming values	Accounts receivable	Cash	Accounts payable	Inventory	Outgoing values	Quantum
Sales	c	d	d				
Collections		c	d				
Discounts allowed		c				d	
Accounts written off		c				d	
Disbursements			c	d		d	
Discounts earned	c			d			
Purchases, payroll, etc.				c	d	d	
Cost of goods sold					c	d	
Net income for period	d					c	c
Total		d	c	d	d		c
Balances at beginning of period		d	d	c	d		c
Balances at end of period		d	d	c	d		c

Note that with the proper columnar arrangement each line begins with a credit. An exception to this is usually a departure from the normal (e.g., returned sales, returned purchases, etc.). Of course, the above is the sketchiest sort of outline. A complete presentation is usually something like this (the numbers indicate the order of the columns):

Incoming values:
1. From equity owners (proceeds of stock issues, assessments, etc.)
2. From operations (sales, revenues, income, etc.)

Receivables:
3. Accounts receivable
4. Notes receivable
5. Reserve for doubtful accounts

6. Cash

Borrowings:
7. Bonds
8. Notes payable

9. Accounts payable (including payrolls and accrued items)
10. Investments

Property assets:
11. Gross book value
12. Reserve for depreciation

13. Deferred charges

Inventories:

14. Raw
15. In process
16. Finished

Outgoing Values:

17. Operations (costs, expenses, charges, etc.)
18. Equity owners (dividends, payments to acquire stock, etc.)
19. Quantum

The arrangement of the columns follows the natural flow of values through the business, and the statement might well be called a "flow sheet."

It is surprising that statements of this character are not more often found in accountants' reports, for they answer a multitude of questions all too frequently ignored. In such statements the character of the sales (credit or cash), the provision for credit losses, the accounts written off, the recoveries, the notes accepted in settlement of accounts, the cash receipts and disbursements, the property and equipment acquisitions, the write-offs and the provision for depreciation, the borrowings and liquidations of loans, the movement of goods from the raw to the finished state, the distribution of the payroll, the charges direct to operations from cash, and so on, are all shown. Statements 1 and 2 complement each other. Statement 1 shows the effect of the operations for the period on the assets and liabilities, while statement 2 (the income statement) analyses and classifies the incoming and outgoing values in the first and next to last columns of statement 1. Together the two statements afford a complete view of the operations for a given period.

An analysis similar to statement 1 is extremely valuable to an auditor for it serves as a basis for applying tests.

Exhibit B

The "whence" aspect of the quantum is displayed in the accompanying exhibit B. The degree to which our accounting statements are conventionalized is revealed by the fact that the vital information given in exhibit B is never found in our present-day reports. Accounting reports are supposed to be historical documents, but most of them are very much like a history of the United States that might begin with the inauguration of the present administration. They are correct enough as far as they go, but they don't go far enough. Exhibit B supplies the missing link as it

yields a picture of the financial history of the business enterprise for its entire life.

Exhibit B shows, on the one hand, how much has come into the business and whence it came and, on the other, how much has gone out of the business and whither it went. It explains the existence of the values now in the business or (as we have defined it) the quantum. It presents a summary of value increments and decrements that is entirely independent of the capital structure. Only through differences in nomenclature can the summary of value origins and dispositions of a corporation be distinguished from that of a partnership or sole proprietorship.

As the statement shows only increments and decrements of value and is independent of capital structure it does not—and should not—reflect such changes as the issuance of a stock dividend and the reduction of the "stated value" of capital stock. These changes are not increments or decrements of value, and they leave the quantum unchanged. If the capital stock were issued for more or less than the par value, only the amount actually received would appear in exhibit B. Like exhibit A, this exhibit answers questions that may be asked of any operating unit quite regardless of ownership relations.

Note, too, that the increments and decrements of value are entirely independent of each other—that is, no decrement is applied against an increment or vice versa. (Net income is, of course, a net amount and so is the net appreciation figure.) Everything received from an equity owner as consideration for the issuance of capital stock increases the quantum and is, therefore, an increment of value. Conversely, every withdrawal by an equity owner, whether for the relinquishment of his equity or as a cash dividend, decreases the quantum and is, therefore, a decrement of value. Note particularly that cash dividends are not applied against the net income, for there is no direct relation between the two! It is true that the *amount* legally distributable is usually based, in part at least, on the amount of the net income, but the latter is merely the measure of the former. It is as absurd to say that earnings, income or profits are distributed as it would be to say that a football victory was distributed to the student body. "Profit," "loss," etc., like "victory" and "defeat," "success" and "failure," are shorthand abstractions indicating the outcome of a train of events.

It is the major asininity of current accounting thought that abstractions are employed as though they were tangible and concrete. Both accounting and legal literature make ridiculous reading in this respect. What we should say in speaking of dividends is that cash equal in amount to the increment through earnings (i. e., a series of transactions) was distributed. Cash is material and tangible and is distributable; earnings, income, etc., are immaterial and abstract, and are not distributable. Cash dividends are simply withdrawals by equity owners and have no connection with income other than that in the long run decrements are limited by increments just as the amount of water that may be taken from a bucket is limited by the amount put in.

In exhibit B the increase through net income (i. e., successful operations) is placed under the increment heading and the cash dividends under the decrement heading. To have applied the cash dividends against the net income (as is the common practice in presenting "surplus") would have misstated the history of the enterprise. We should have a similar misstatement were an historian to argue that inasmuch as Austerlitz was a victory for Napoleon and Waterloo a defeat, the one offset the other and neither took place.

We need better generic terms for the funds advanced to and withdrawn from an enterprise by equity owners. "Withdrawals" might pass muster (though a bit pompous) but we have no good term for the converse— "contributions" sounds too much like an act of benevolence. Perhaps we might borrow from our engineering brethren and say simply "in-put" and "out-take." The consideration for the issuance of capital stock, assessments levied on stockholders, and so forth, then may be called in-puts of value, and the amounts paid by a corporation in acquisition of its own stock, cash dividends to stockholders, etc., are out-takes. Incidentally, the term "dividend" is misused, though it is no doubt beyond hope of correction. Strictly speaking, "dividend" means that which is to be divided. In accounting we use the word both in this sense and to denote the individual parts of the whole after division has been made.

The exhibit B or "whence" statement presented here is a relatively simple one. If there is more than one class of capital stock there will be columns under the "increment" heading for each class and under the "decrement" heading for dividends thereon. Usually sundry columns are necessary under

both the increment and decrement sections in order to show unusual items (fire losses, life-insurance collections, judgments, etc.). These may be keyed by means of reference marks to explanations at the bottom of the page.

The column totals in exhibit B might be summarized for clearer reading, but as such a summary is presented in exhibit C it is unnecessary here.

Statement 2

Statement 2 will show "how" the increments and decrements varied during a given period, usually a year. It corresponds closely to the conventional income statement. What is now customarily presented as a major accounting exhibit is seen to be logically subordinate to a non-existent basic exhibit. This statement usually supports or amplifies the details for one or more of the years summarized in exhibit B. While this statement is not greatly different from its conventional counterpart, it is so arranged that the figures for the various columns in exhibit B are brought out distinctly. For example, a comparative statement might end as follows:

	Year Ended December 31st		
	1935	1934	Increase
Net income for year	$ 120,037	$ 38,349	$81,688
Less depreciation based on appreciation	2,826	2,826	
Remainder	$ 117,211	$ 35,523	$81,688
Other increments:			
Proceeds of stock issues	12,250	1,840	10,410
Gross increment	$ 129,461	$ 37,363	$92,098
Decrements:			
Dividends	$ 45,000	$ 37,000	$ 8,000
Payments to acquire stock	2,250		2,250
Total	$ 47,250	$ 37,000	$10,250
Net increment for year	$ 82,211	$ 363	$81,848
Quantum at beginning of year	1,299,431	1,299,068	363
Quantum at end of year	$1,381,642	$1,299,431	$82,211

A complete list of captions for a statement of this sort would be something like the following:

1. Sales
2. Cost of sales
3. Gross profit
4. Selling expenses
5. Net profit on sales
6. General and administrative expenses
7. Profit from operations
8. Other income credits
9. Gross income
10. Income charges
11. Net income for period
12. Other profit-and-loss credits
13. Gross profit-and-loss
14. Profit-and-loss charges
15. Profit-and-loss for period
16. Other increments
17. Gross increment
18. Decrements
19. Net increment for period
20. Quantum at beginning of period
21. Quantum at end of period

Obviously, as many years as are desired can be presented in a statement of this character. A complete analysis of the operations might call for at least annual statements for the entire life of the enterprise.

Exhibit C

Exhibit C is a statement designed to show "whether" or not cash distributions may legally be made to equity owners and, if so, to what extent. Before presenting it, let us consider further the relation of statutory requirements to accounting.

A considerable portion of the regulatory legislation directed at corporations concerns itself with the limitation of cash distributions to equity owners. There have been two distinct attitudes of legislators toward the matter of cash dividends. The original idea was that dividends should not exceed the amount of the earnings. This, while still the fundamental notion, has been modified somewhat and may now be expressed as the generally held belief that the sum of the dividends and the amounts disbursed by a corporation in acquisition of its own stock should not exceed the amount of the earnings.

The idea that dividends should be limited (in whole or in part) by the amount of the earnings is based on the naïve assumption that the affairs of an enterprise are static. It is argued that if so much capital is needed to start a business, the initial amount should never be reduced by distributions. Little thought seems to have been given to the danger of permitting the investment to be reduced to or maintained at this initial figure should the business expand. Many—perhaps most—successful corporations would commit suicide were they to pay dividends to the extent legally permissible.

The basing of the dividend limitation upon earnings is erroneous to the point of stupidity, as it causes distributions to be regulated by historic rather than by material factors. The advisability of a cash distribution depends logically upon two, and only two, factors, namely:

1. The current financial status.
2. The probable future requirements of the business.

The first is always determinable; the second must be estimated—and the estimating requires the exercise of judgment and is subject to the errors of the fallible human mind.

Consider three corporations with similar assets and liabilities but with their capital structures set forth in the conventional manner as follows:

	A	B	C
Capital stock	$ 100,000	$ 980,000	$1,200,000
Surplus	900,000	20,000	200,000*
Total	$1,000,000	$1,000,000	$1,000,000

* Deficit.

One can legally declare a very large dividend, one a very small dividend and the third none at all—yet the financial status of each is the same as that of the others. Why the discrimination? You may say appearances seem to indicate that A is a highly prosperous enterprise, that B is barely holding its own and that C is a failure. If these assumptions are correct they throw light on the future requirements of the business and are the factors to be considered—not historical data. On the other hand, perhaps A is fifty years old and has slowly accumulated its present capital over a long period, B is three months old and "going strong," while C, five years old, has recovered from a disastrous beginning in hard times, is now well stabilized on its present set-up and is the most profitable of the three.

It is obvious, then, that no intelligent idea as to the advisability of a cash dividend may be obtained without an analysis of the current financial condition (with full regard to the rights of creditors) and an estimate of the future needs of the business. The progress of a business enterprise is like that of a man rowing against a variable current. Either he forges ahead or is borne down stream. Only for brief periods is he apt to maintain a stationary position. It is rare that a business proceeds at the same rate for any great length of time, and its needs for fixed and

operating capital vary. It is paradoxical but true that a successful business may not only be unable to pay dividends but must have more capital in order to maintain its place in industry. How absurd it is, then, to regulate dividends by the origins and dispositions of values. Under current legislation the expanding business is graciously given permission to cut its own throat, while the declining business or the business founded on a wasting asset (mine, oil well, timber tract, etc.) must keep useless funds impounded.

The so-called stock dividend is a clumsy and ludicrous expedient to correct the first ill. When it is apparent that a corporation requires permanently more capital than originally invested by the shareholders, more certificates of stock are solemnly issued, and "surplus" is reduced and "capital stock" is increased. It seems to have occurred to no one that the issuance of more shares and the raising of the amount to be retained permanently in the business are two entirely dissociated acts, either of which may be performed without the other.

The only legitimate reason for the issuance of more shares is convenience. When the value per share increases beyond a convenient amount, additional shares may be issued in order to reduce the value per share. This issuance of new shares should not be misnamed a "stock dividend" but should be called a more fitting term, possibly a "share augmentation."

If it becomes desirable to raise formally the limit below which the quantum may not be reduced by cash withdrawals, let an appropriate resolution fixing the amount be voted by the shareholders and registered with the corporation department of the state. It should be as simple as that. No additional stock need be issued; none of the lumbering, creaking machinery of the present day need be set in motion. It does not reflect credit upon the analytic faculties of accountants that the "stock dividend" has been accepted as the sole and unquestioned means of restricting cash dividends in an expanding business. The sooner it is recognized that share augmentation and dividend restriction are two azygous acts, the sooner will our concepts be clarified.

We need terms for the amount that may legally be distributed to shareholders and the amount below which the quantum may not be reduced by distributions. The latter might be called the "retain" or something similar, but it is difficult to find a corresponding term for the distributable amount. As both these amounts depend upon statute, they may be called "statutory

corpus" and "statutory surplus" for want of better terms. The statutory corpus is simply a minimum quantum for the enterprise. As long as the actual quantum is greater than this minimum, distributions may be made to the extent of the excess, or statutory surplus. The statutory corpus, then, is no more nor less than a reverse Plimsoll mark, indicating the point beyond which the "unloading" may not proceed.

Again it must be emphasized that these terms are abstractions or magnitudes. The abstract quality of the concepts would be more evident if we said "corpus amount" and "surplus amount." The loose and absurd expressions in common use ("The dividend was paid out of surplus," "The reserve was created out of surplus," etc., etc.) are reflections upon the intelligence of accountants. A dividend is paid out of cash. The reduction of the asset reduces the total values in the enterprise (quantum) to an amount not less than the legal limit (statutory corpus) leaving, usually, an amount (statutory surplus) in excess thereof, indicative of the extent to which further distributions are legally permissible.

The corpus amount and the surplus amount depend solely upon statute. That statutory formulas for the computation of the surplus amount now are based upon earnings is merely incidental. The measure of dividends need not be earnings at all but could be anything legislators might care to designate. Historic factors —origins and dispositions—are absurd guides for the determination of anything so dependent upon financial status as dividends and should be abandoned in favor of material factors. The elements now employed in our computations of statutory surplus are found in exhibit B, whereas logically they should be derived from exhibit A.

Exhibit C, setting forth the computation of statutory corpus and surplus as of December 31, 1935, in accordance with prevailing ideas, may be presented as follows:

Exhibit C

	Total	Computation: Corpus	Computation: Surplus
Increments, per exhibit B:			
Equity owners:			
Proceeds of stock issues:			
Original	$1,100,000	$1,100,000	
Reissues	14,090	14,090	
Assessment	45,000	45,000	
Total	$1,159,090	$1,159,090	

Net income from operations......	$ 827,004		$827,004
Appreciation of property assets less depreciation based thereon.	36,738	$ 36,738	
Total increments...........	$2,022,832	$1,195,828	$827,004
Decrements, per exhibit B:			
Equity owners:			
Cash dividends...............	$ 523,500		$523,500
Payments to acquire stock.....	117,690		117,690
Total decrements...........	$ 641,190		$641,190
Net increments..................	$1,381,642	$1,195,828	$185,814
Statutory transfers:			
By stock dividend (1,000 shares).		100,000	100,000*
By reduction of capital stock from 11,000 to 7,500 shares.........		350,000*	350,000
Quantum.......................	$1,381,642		
Statutory corpus.................		$ 945,828	
Statutory surplus.................			$435,814

* In red.

It should be emphasized that the allocation of the elements of exhibit B between the corpus and surplus columns of exhibit C is simply a computation. The "net income" is not "put into" surplus nor are dividends "paid out" of surplus. The surplus is merely an amount equal to the algebraic sum of the positive and negative amounts employed in the computation.

It is instructive to compare this formula for computing the surplus amount with one based on the current financial status and the probable future requirements of the business. I have not here presented an exhibit A or balance-sheet, but let us say that it reflects the figures employed in the following computation:

	Total	Corpus amount	Surplus amount
Property, less depreciation..........	$ 577,023	$ 577,023	
Patents, less amortization...........	127,315	127,315	
Securities........................	177,912	177,912	
Working capital (excess of current assets and deferred charges over current liabilities)	649,392	625,000	$24,392
Total......................	$1,531,642	$1,507,250	$24,392

Bonds	$ 150,000	$ 120,000	$30,000
Remainder	$1,381,642	$1,387,250	$ 5,608*
Estimated effective accretions from future earnings		52,250*	52,250
Total	$1,381,642	$1,335,000	$46,642

* In red.

In exhibit C the statutory surplus, or the amount distributable, is computed in accordance with a legalistic formula, and the excess over the amount so obtained is the corpus amount. In the computation above, the corpus, or the amount that must be retained, is computed and the excess is the surplus amount. The two methods of approach are diametrically opposed. The first is academic; the second realistic.

Under the method of computation illustrated above, the balance-sheet values of the so-called "fixed assets" are always included in the corpus column. It is a matter of indifference in making the computation whether the property assets are written down to a dollar or raised to an appraised value of a billion dollars, as long as the value of these assets is one of the positive elements upon which the quantum figure is based. Except in extraordinary circumstances, property values are obviously not in distributable form and the same principle holds true for patent rights and other intangibles.

The company whose statement is presented above has been in business for eleven years and is now faced with the prospect of heavy machinery replacements. In anticipation of such replacements, a considerable sum has been invested in readily marketable securities, and the directors believe that the funds so invested are not available for distributions. (In other circumstances these securities might not be included in the computation of the corpus.)

The officers estimate that not less than $625,000 of working capital will be needed. The ratio of working capital to the anticipated sales has been greater in the past, but by economies incident to greater volume, by a quicker turnover and by the reduction of inventories bought in anticipation of a rising market, the officers expect to operate on $625,000. This much of the working capital, then, is clearly not distributable and shoul' be included in the corpus computation.

This leaves only $24,392 of working capital available for distributions, but this amount is insufficient by $5,608 to cover the bond instalment of $30,000 maturing during the coming year. However, allowance is made for the effect of accretions to working capital during the ensuing year (the computation of the adjustment need not be given here) and it is estimated that the surplus amount may safely be increased by $52,250, making this amount $46,642.

The corpus amount is reduced by the deferred bond instalments, $120,000, as there is every reason to believe that the increment through earnings in future years will be more than adequate to cover the annual instalments of $30,000 each.

The comparison of this computation with that in exhibit C is instructive. In the latter the statutory surplus has been computed in accordance with prevailing ideas, that is, the amount has been derived from a consideration of historic factors. The application of this academic formula indicates that $435,814 was legally distributable at December 31, 1935. Needless to point out, were the corporation to distribute this amount it would either commit suicide or reduce its operating capacity to a point below that warranted by its investment in plant and patents. A consideration of factual elements indicates that the company can not distribute much in excess of $45,000; and even that amount is defensible only upon the assumption that additional funds from operations will become available during the ensuing year. This is a typical illustration, and only conscientious and intelligent direction by officers saves many corporations from fatal dividend policies. Some day, perhaps not in your time or mine, legislators, state controlling agencies, executives and even accountants will actually be obliged to think about this question of dividends. The days of formula application will be over.

Any taxation of "surplus" based on an historic formula will be a monument to the ignorance and asininity of this our age. To tax a "surplus" determined from historic factors is to kill the goose that lays the egg. For example, let us say that $1,000,000 of capital is needed for the operation of a certain business. A corporation is formed, the equity owners put in $600,000, and $400,000 is obtained by issuing bonds. The company prospers and the bonds are liquidated. But the company still needs $1,000,000 to operate and it must, therefore, reflect on its books an historic "surplus" of not less than $400,000. It could not

distribute the amount of this falsely termed surplus without committing suicide! If its business has expanded so that capital of $1,500,000 is now needed, its books must show an historic "surplus" of not less than $900,000, and so on. To call any portion of the essential capital of an enterprise "surplus" is as silly as to term the engine or wheels of a truck "spare parts"! It must be realized that the historic origins of capital have no bearing whatever on a material status.

Exhibit D

Exhibit D is designed to display the "who" aspect of the quantum. Here the relations between the business and its owners are set forth in detail and here the interests of each class of owners in the quantum, or total value of the enterprise, are shown. This exhibit is the least conventional of all as to form, and in simple cases the information usually set forth therein may be less formally presented in the comments.

In complex cases, particularly where there are several classes of equity owners, the statement deserves a place among the primary exhibits. It will show rights, preferences, equities, the annual earnings per share of stock, the dividends per share, the effect of issuing large blocks of stock for considerations at variance with book values, and so on. In short, it will display to owners and prospective owners the rights and book value of any equity unit.

The form of the statement will vary so much with individual cases that no attempt is made here to do more than to outline the salient features of a typical exhibit D. Such an exhibit should show at least the following:

I. Incorporation data.
  a. Date of incorporation
  b. State
  c. Period covered by the charter
  d. Principal purpose of incorporation
II. Description of capital stock
  a. Number of shares authorized and par value (if any)
  b. Number of shares outstanding at balance-sheet date
  c. Dividend rates
  d. Retirement provisions
  e. Assessment liability
  f. Dissolution rights
  g. Voting rights
  h. Other significant features

III. Equities of each class of stockholder
 a. Total value of each class of stock
 b. Value per share of each class of stock
IV. Chronological table of issues, acquisitions, reissues and retirements
V. Other data.

The incorporation data may be covered briefly in two or three sentences, as "The company was incorporated on January 16, 1925, under the laws of the state of Delavania for the principal purpose of manufacturing and selling gadgets. The corporate charter covers a period of fifty years."

The appropriate descriptions of each of the several classes of stock should follow the sub-headings under II, as, for example:

Authorized (par value, $100.00 a share):
 Preferred, 7,500 shares
 Common, class A, 6,000 shares
 Common, class B, 1,500 shares
Outstanding at December 31, 1935:
 Preferred, 5,000 shares
 Common, class A, 2,000 shares
 Common, class B, 500 shares

and so on. In this manner the rights and preferences of the various classes of stock may be readily compared.

The equities of each class of owner may be shown somewhat as follows (the same quantum amount is employed for illustration as in exhibits B and C although the corporate structure is different):

	Quantum	Non-distributable amount (Corpus)	Distributable amount (Surplus)
Preferred	$ 525,000	$525,000	
Common, class A	685,314	336,663	$348,651
Common, class B	171,328	84,165	87,163
Total	$1,381,642	$945,828	$435,814
Value per share:			
Preferred	$105.00	$105.00	
Common, class A	342.65	168.33	$174.32
Common, class B	342.65	168.33	174.32

The preferred stock is stated above at the retirement and dissolution value of $105 a share. The excess is the book value of the common stock. Both classes of common stock share ratably in the event of dissolution. As no preferred dividends were in arrears, the statutory surplus is applicable entirely to the common stock.

A chronological summary shows briefly the changes in the equity units, for example:

			Common	
		Preferred	Class A	Class B
1925–26	Issued for cash at $100 a share.....	6,000	4,000	1 000
1927–28	Retired at $105 a share...........	1,000*		
1929	Stock dividend (statutory corpus increased and statutory surplus decreased $100,000)..............		800	200
1932	Common shares reduced ratably from 6,000 to 2,500 shares with consequent transfer of $350,000 from statutory corpus to statutory surplus........................		2,800*	700*
1933–35	Common shares acquired at average price of $87.52 per share.........		145*	
1934–35	Common shares reissued at average price of $97.17 per share.........		145	
	Total......................	5,000	2,000	500

* In red.

Further data as to dividends per share, earnings per share, the effect on equities of issuing or retiring large blocks of stock at figures markedly different from book values, and so on, may be added to this exhibit.

Accounting phraseology would be clarified considerably if we refrained from speaking of capital stock as "sold" by the issuing corporation. A stock certificate is simply an evidence of ownership issued as a receipt for the contribution of something of value by the owner. It is not "sold" by the issuing corporation any more than a warehouse receipt, a hat check or a pawn ticket is "sold" when issued. It is, no doubt, legitimate to speak of the sale of stock by an owner to another person as this is a transfer of ownership from one person to another, but a corporation does not "sell" or "buy" its own stock. It issues certificates as evidences of "in-puts" and receives them for "out-takes" involving the relinquishment of equities by erstwhile owners.

A corporation can not "own" its own stock, and there is logically no such thing as "treasury stock"—unless this term be used purely in a legal sense to denote a number of shares that may be reissued. No amount designated "treasury stock" should ever appear on a balance-sheet. Every disbursement to an equity owner for the relinquishment of his equity decreases the quantum

and should be shown under the caption of decrements in exhibit B. Any other treatment falsifies the quantum amount.

RÉSUMÉ

Reference to the accompanying diagram shows that exhibits A and B are classified as "independent" statements. The data reflected by these exhibits are common to all business enterprises and are entirely independent of ownership relations. They reflect the present status and past history of the entity considered solely as an operating unit. All statutory and proprietorship aspects are foreign to these exhibits and are displayed elsewhere. Only by technical differences in nomenclature may the exhibits of this nature for a corporation be distinguished from those for a partnership or sole proprietorship. Exhibit A shows by what the total value (quantum) of the enterprise is represented and exhibit B shows whence it was derived—and these are the basic factual elements of any enterprise. It follows that exhibit A does not show "capital stock," "surplus" or any similar items, for these relate to other aspects of the quantum. Exhibit B states separately all increments and decrements of value and does not apply dividends against earnings or offer other similar follies. It shows a summary of the operations from the inception of the business, a statement now wanting in accounting reports.

Exhibits C and D are on the dependent side of the diagram, for the data reflected by them are not common to all enterprises but are derived from statutes or from contractual arrangements with equity owners. The purpose of exhibit C is to show the amount that may legally be distributed to equity owners, and the computation rests solely upon statute. At present the statutory formulas are universally based on historic factors and not on material factors. The elements used in the computation are derived from exhibit B, whereas logically they should be derived from exhibit A and viewed in the light of the probable future requirements of the business. Exhibit D displays compactly the rights, privileges and equities of the various classes of shareholders.

In viewing these statements one is at first a little uneasy at not finding in the balance-sheet his old friends, "capital stock," "capital surplus," "earned surplus" and their ilk. They are absent simply because logically they do not belong there. Of course, there is no law of God or man that says one may not mix categories, just as there is none against mixing drinks, but in either

case one is apt to get weird results. It would be perfectly feasible to incorporate an entire income statement in a balance-sheet—all one need do in the conventional arrangement is to indent sufficiently under the caption of "surplus" and write in the items. We don't do this because such an arrangement would be an obvious confusion of categories. Yet in a half-baked sort of way we attempt something similar when we include "capital stock," "surplus," et al.

But we lose sight of the fact that to do even this we must subscribe to the tenets of some school or other. For example, one of the die-hard school might wind up his balance-sheet as follows for the corporation whose accounts appear in exhibit C:

Capital stock—7,500 shares of $100.00 each	$ 750,000
Assessment on common stock	45,000
Surplus arising from appreciation	36,738
Capital surplus (reduction of common stock)	350,000
Earned surplus	199,904
Total	$1,381,642

This man may believe in crediting "earned surplus" with the profit on stock acquisitions and charging it with the premium on the stock retired. Other brethren might have different ideas—it does not matter for our illustration. If the above is intended to give an idea of origins—and obviously it is—it fails pitifully. The amount, either gross or net, received for the issuance of the stock was not $750,000. The amount of the earnings in excess of cash distributions was not $199,904. No intimation of the amount legally distributable ($435,814) is to be derived from the summary. In short it is a stupid and meaningless botch.

On the other hand, a member of the legalistic school might present the following on his balance-sheet, in accordance with the formula in exhibit C:

Capital stock	$ 864,090
Assessment on common stock	45,000
Appreciation	36,738
Surplus	435,814
Total	$1,381,642

This does show the amount that may legally be distributed, but the "capital stock" figures are so fantastic that the attempt to attribute sense to them fairly makes one dizzy. The legalistic

school hews to the line as to statutory surplus, but it certainly lets the chips fall where they may in other respects.

Or, once more, suppose that we live in a more enlightened age and that the amount legally distributable has been computed from material factors in the manner which I have set forth. The elements of the computation do not include "capital stock," "assessments," "earnings" or other historic factors, and about all that could be shown on the balance-sheet is the following:

Statutory corpus	$1,335,000
Statutory surplus	46,642
Total	$1,381,642

It is evident, then, that every attempt to present subdivisions of the quantum in the balance-sheet must be based on the dictum of some school of accounting thought. The results presented by both the die-hard and the legalistic schools are unscientific, distorted and essentially meaningless. Both evidently endeavor to show in a crude way origins and dispositions of values, and both fail. They fail because each in its blundering way is trying to present something of the "whence"-"whether"-"who" aspects, and neither expresses the whole of any one of them. It is quite impossible to express in the balance-sheet one or more of these extraneous aspects except in extremely simple cases where several of the aspects coincide, as for example:

Capital stock		$100,000
Surplus:		
Net income	$88,674	
Dividends	65,000	23,674
Total		$123,674

Even in this simple case it would be impossible to present both the "whence" and "whether" aspects if the surplus were computed (as it should be) from material and not historic factors.

The acceptance of the principle upon which the suggested exhibits rest—that one and only one aspect of the quantum may logically be presented in a single statement—would effect an immediate clarification of our primary accounting concepts. We should better be able to see just what our objectives really are and what is the best way to attain them. Certainly it would sweep away much of the prevailing confusion in accounting thought. No advancement, no scientific development of accounting principles, is possible in a fog of confused concepts.

Quite naturally, progress can not be made faster than new thoughts are received by those who are accustomed to read accounting statements, and this means that a large non-technical group must slowly be educated. The shock of seeing a balance-sheet without "capital stock" or "surplus" on it would be severe in many quarters, no matter how logical such a treatment might seem to the accountant presenting it. The statutory surplus amount is always of interest to the investor or creditor and the balance-sheet caption might well read as follows:

Quantum (statutory surplus, $435,814).......... $1,381,642

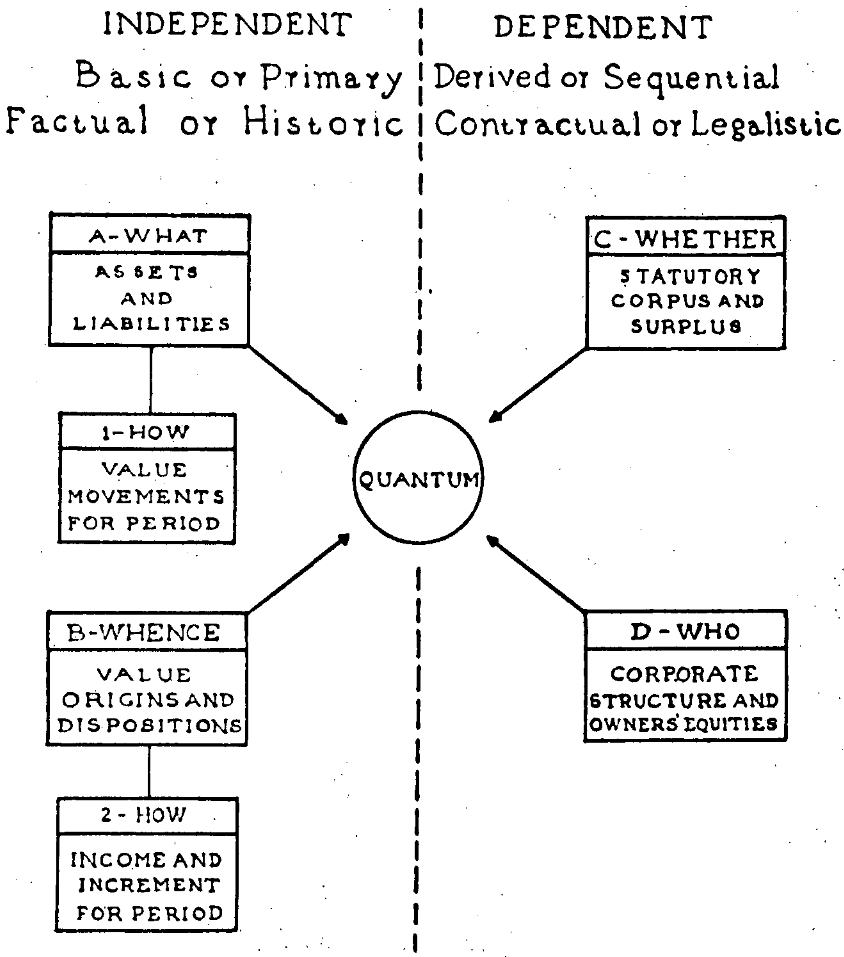
If a summary of data regarding origins and dispositions or ownership relations is desired on the balance-sheet as a matter of convenience, an asterisk placed before the quantum caption may refer the reader to a summary at the foot of the page and thence to a following exhibit for further details.

The question arises as to the manner in which accounting records should be maintained in order to reflect the basic aspects of the business. Obviously, the records should reflect at all costs the primary factual elements presented in exhibits A and B. At the end of the year the operating accounts may be closed directly into the quantum account, and the books after closing will show only balance-sheet items. A set of subsidiary accounts whose control is the quantum account will disclose the facts reflected in exhibit B. In simple cases an analysis ledger sheet for the quantum account will supply the necessary data. The computation of the statutory corpus and surplus may be carried on in another set of subsidiary accounts controlled by the quantum account or, in simple cases, the computation need be made only in statement form when desired, as it will be based on the elements either reflected elsewhere in the accounts or readily available. A similar set of subsidiary records will supply the data relating to the corporate structure set forth in exhibit D.

The treatment of capital stock with par value is precisely the same as the treatment of capital stock without par value. This is as it should be, for a certificate of stock simply gives evidence of the title to an aliquant share in the enterprise. The amount actually received from the equity owner will show in the statements, regardless of what is printed on the certificate.

In closing, it should be said that the statements here described are revelatory only and are not designed to be interpretive.

They supply the basis for interpretive statements by a full disclosure and logical arrangement of factual elements. A clear understanding of primary concepts must precede intelligent attempts to interpret financial data, and, if we have this, accountancy will be in a position to advance under its own steam.



GADGET MANUFACTURING COMPANY

Exhibit B

Summary of value origins and dispositions from the commencement of business to December 31, 1935

			Increments					Decrements	
			Proceeds of stock issues						
Year	Quantum	Net annual increment	Original	Reissues	Assessment	Net income	Appreciation of property	Cash dividends	Payments to acquire stock
1925	$ 776,445	$ 776,445	$ 750,000			$ 63,945		$ 37,500	
1926	1,151,496	375,051	350,000			113,051		88,000	
1927	1,172,343	20,847				181,597		82,000	$ 78,750
1928	1,265,982	93,639				143,369	$56,520	80,000	26,250
1929	1,312,606	46,624				148,450	2,826*	99,000	
1930	1,306,199	6,407*				51,419	2,826*	55,000	
1931	1,303,563	2,636*			$45,000	44,810*	2,826*		
1932	1,279,506	24,057*				21,231*	2,826*		
1933	1,299,068	19,562				32,828	2,826*		10,440
1934	1,299,431	363		$ 1,840		38,349	2,826*	37,000	
1935	1,381,642	82,211		12,250		120,037	2,826*	45,000	2,250
Total		$1,381,642	$1,100,000	$14,090	$45,000	$827,004	$36,738	$523,500	$117,690

* In red.

73626

Present Condition of Municipal Accounting*

By Arthur N. Lorig

The accounting for municipal governments varies considerably from that commonly practised by private industry. So greatly do they differ that even an experienced auditor, in examining the books of a municipality for the first time, may find himself uncertain as to the necessary procedure. Moreover, he may distort the results he presents according to inappropriate principles learned in his accounting for private industry. An understanding of the specific financial requirements of municipal governments is prerequisite to proper accounting and reporting for such an organization.

Municipal accounting may be defined as the use of accounts and other records in recording and presenting the financial aspect of municipal government, disclosing the financial condition at any given time, the results of operations, and other financial information pertinent to good management and control. The nature of municipal government—its organization, the services performed, the manner in which income is obtained and the policies followed—determines the character of the financial information needed, and this in turn determines the type of accounting system required to supply the information.

Included as part of the organization of municipal government are four principal groups—the citizens, the legislative body (usually termed the council), the executives, and the minor employees. Their interrelationships establish a certain condition and order of accountability. The minor employees are accountable to the executives for the work assigned to them and for goods and properties entrusted to their care. The executives are accountable to the council and (in the case of elected officers) to the citizens for materials and properties under their control, for the collection and safeguarding of money which may come under their jurisdiction, and for the efficient performance of the activities under their supervision. The council is accountable to the citizens for the total cost of the government, as compared to the

* This interesting survey of the facts and needs of municipal accounting does not attempt to deal with the legal obstacles caused by a multitude of state laws. The author does not mention but would doubtless be prompt to admit the very valuable work now being done by committees in municipal accounting, notably the committee of the American Institute of Accountants.—Editor.

standards of service given, the tax rate, the financial condition of the municipality and the credit standing of the municipal government. This accountability should be reflected in the accounting system in such a manner that financial information desired by any of the groups may be obtained promptly and accurately.

The executives endeavor to control the expenditures and the collection of money for which they are made responsible. The council, with a broader responsibility covering the entire cost of municipal government, the imposition of taxes, and the borrowing and repayment of funds, controls the executives in their expenditure and collection of money. Citizens, interested in good government and relatively low taxes, seek to control the council and elected officers. For these purposes several direct instruments of control may be used—the budget, acts of council and popular referenda. To make the control devices effective, the accounts must disclose whether the restrictions imposed and authorizations granted are being properly observed.

The nature of the services performed by municipal government directly affects the nature of accounts. Services are many and varied, including such widely differing activities as paving streets, providing for the poor, acting as trustee and disposing of dead animals. For determining policies in regard to offering various services and for controlling their performance, information should be made available as to the cost of each service and the income, if any, obtained from it. With the increase in the number of services offered by governments, there occurs an increase in the number and variety of accounts necessary to show the financial aspect of public services.

The manner of obtaining income also has an effect upon the nature of the accounting system. There are many sources of income, each of them requiring separate accounting. Furthermore, the amount of income obtained through services performed, through the ownership of property or in other ways not dependent upon direct legislative action is usually much too small to pay for needed expenditures; and the deficiency in any one year must be made up through taxing or borrowing. The amounts to be obtained in this way should be estimated in advance if the financial machinery is to run smoothly. For this reason, accounting information upon which to base estimates of future income and expenditures must be made available.

Nature of Financial Information Needed

Financial information concerning municipal government is needed by executives, members of council, and citizens; and it may also be desired by other governments, creditors (including investors in municipal securities) and students engaged in research. Other governments may seek information in order to control the activities or fiscal policies of municipalities—in debt incurrence, for example—or they may merely wish to compile helpful statistics. The creditors are interested in determining the risk involved in lending money or in analyzing the prospect of repayment, once money has been lent. Students engaged in research may have numerous purposes in mind.

The specific nature of the information desired by various groups must be understood before a proper accounting system can be prepared. The classification of accounts, framework of the accounting system, should be designed both to accumulate and present the information economically in the quickest and clearest manner. It is impossible to foresee all the forms such information might be required to take, especially in compiling operating statistics where the executive may often call for new kinds of data. But there are certain rather standardized kinds of information, regularly sought, which should be obtainable from the accounts. They are of concern in the development of a classification of municipal accounts.

The classification can not in itself be expected to supply every kind of regularly desired financial information. For some data it may be necessary to regroup certain of the accounts. If, for example, object accounts are subsidiary to activity accounts in the classification, the object costs for a department performing more than one activity can be obtained only by separately adding the similar object costs of its activities or by reclassifying the items. In case special information is desired, it may even be necessary to analyze accounts into further detail.

The financial information suitable to meet the needs of one group will usually vary in some particulars from that useful to the others. Consequently, an analysis of the typical requirements of each group and, in the case of executives, of different members within the group is desirable.

Operating executive.—The operating executive (one in charge of an operating unit) must know the relation of the amount of

expenditures he is making to the amount appropriated to his organization unit. If the appropriation is divided among the various activities and objects of expenditure and is further subdivided by months or quarters of the year, he should be regularly informed, through operating statements, of the relationship between the expenditures and the appropriation or allotment details. Special fund requirements may also need to be observed. One indication of the efficiency of the executive is his ability to make the expenditures according to the purpose and limitations set forth in the budgetary and fund restrictions. The accounting should reveal whether he is succeeding in doing this and may thereby serve as a constant guide to him.

The operating executive may be made responsible for the collection of income from various sources. The amounts actually received, compared with the amounts expected from the sources, give information helpful to him in ascertaining the state of income collection and in determining the collecting policy to follow in the near future. He is also responsible for the properties, materials, supplies, cash and other assets under his direct control. Periodical inventories, a method of stores accounting and a system of internal check help to verify the assets or to warn him if some are disappearing. His control over employees and his judgment in deciding on methods of performance may be aided by unit costs and by various kinds of operating statistics. It is possible that a comparison of unit costs or object costs between cities will disclose, prima facie, the relative efficiency of employees and methods of operation, thus affording a better basis for administering his organization unit.

Chief executive.—The chief executive uses the same kind of information as the operating executive so far as his own department is concerned. To a less extent he needs similar information regarding all organization units, for one of his duties is to see that the various departments follow policies and financial plans made by the council. Statements of financial condition of funds and appropriations also are of use in exercising this responsibility.

The preparation or approval of a new budget is ordinarily another task of the chief executive. Certain kinds of accounting information are necessary to the proper performance of this work. Information as to the financial condition of various funds and appropriations helps to reveal whether a surplus will be available to be carried forward for use in the next period or deficits might

occur necessitating charges against future income; whether changes might be made to advantage in certain estimates of expenditures for the coming period and whether the policies followed in debt incurrence and retirement have been satisfactory. Knowledge of income during past and present years (classified by funds to which it accrues and sources from which it comes) compared with the income estimated for the present year and the income expected for the coming year is useful in approving estimates. Information as to actual and estimated cash receipts for the same years, similarly classified, help to determine the collectibility of expected income and the time of collection. If appropriations are to be based on expected cash receipts instead of expected income, the information regarding cash is even more important.

For budgeting purposes, the chief executive also needs information as to expenditures, classified by the funds from which they are paid, by their general character (e.g., operating expense, debt redemption and interest), by the organization units making the expenditures, by the activities for which they are made and by the object of expenditure (the kind of article or service obtained). Records of actual expenditures in past and present years give aid in judging budgetary estimates for the coming year. Unit costs of performing certain activities or operations, determined from past experiences, would also help in appraising the estimates.

Information on the details of the public debt must be available when preparing or approving the budget. These details should cover redemption and interest requirements, the status of the sinking fund, debt limitations and the kind of debt involved in the limitations—all essential in formulating a financial plan.

Controller.—The controller, who is in immediate charge of the accounting system, is concerned with providing all the financial information necessary to the proper administration of the system. Ordinarily the controller is, and should be, charged with seeing that appropriations are not overexpended and that all financial restrictions are observed. His authorization should be required on all expenditures, warranting that appropriations are available for paying them and that they are in conformity with fund stipulations, budget standards or requirements or any other controlling factors. Hence, he must have information as to the nature of all expenditures, the funds from which they are to be paid, and the condition of the appropriations—i.e., the amount of the original appropriations and the expenditures and encumbrances already

applicable thereto. Before authorizing the payment of charges, he must know the financial condition of the funds from which they are to be paid. If cash is low and payrolls or other more pressing liabilities must be met in the near future, it may be necessary to postpone paying the present charges or to borrow money temporarily. In planning which to do, he must know what other resources are in the funds, when they may be expected to be converted into cash, and the kind, amount and due date of the other liabilities. This information may also indicate the need for a firmer collection policy, or it may even show the possibility of investing funds temporarily.

In his capacity as head of the accounting department, the controller is responsible for the accuracy of the accounting information. An important degree of accuracy (assuring, to some extent, accurate posting and computing in the books and the recording of all current assets and liabilities) is obtainable through the use of a system of internal check. It is to the controller's advantage to adopt an accounting system which permits internal checking.

Treasurer.—The treasurer desires information regarding his own department similar to that required by other operating executives. In addition, as custodian of the cash, he should be prepared to report the receipts, disbursements and cash balances by funds at any time, usually daily, and in sufficient detail to permit their verification. His report to the controller should classify the receipts by sources (including as a source the various accounts receivable) and the disbursements in a manner which permits their verification with the warrant register or other record of authorization for payment.

Council.—The councilmen (aldermen, commissioners or selectmen), in approving or initiating the budget, require information for the purpose. If additional appropriations become necessary during the year, or restriction of expenditures becomes desirable, because of failure to realize some of the expected income, or additional borrowing seems necessary, or transfers between appropriations are requested, information disclosing the need must be submitted to them. This would probably best take the form of a comparison of actual income and expenditures with the estimated amounts to date or for the year (possibly limited to the particular kinds of income and expenditures necessitating the change). New estimates covering the balance of the year should also be included.

The council should also be given periodic reports of the condition of funds and statements of income and expenditures. By keeping in constant touch with the financial side of government, they may see reasons for altering certain policies and restrictions or adopting new ones.

Citizens.—Citizens (taxpayers) should be informed as to where the municipality obtained its money (income and receipts classified by fund and sources), where the money went (expenditures classified by fund, character, organization unit, activity and object), the financial condition of the funds, the efficiency of operation, the honesty of the executives and other employees, and the future financial program. The necessity for this information has already been stated.

Other governments.—The interest of other governments in the accounting for municipalities might take various forms. The state may prescribe uniform systems and may audit the accounts periodically to see that they are properly kept. The information they would desire would then be that which would be most helpful to the municipality itself. This information has been already described.

When comparable data from the various municipalities are sought, the objective is again chiefly that of helping local officers. Hence, the needs of officers for accounting information in general, will indicate the nature of the information, sought by the other governments for statistics. Additional information may be required for control of debt and of expenditures from grants-in-aid, but this information also would be available if the needs of the officers were satisfied.

Creditors.—The creditors, in desiring to determine the risk involved in lending money to a municipality, would wish information as to the financial condition of funds, the details of the public debt and the financial plan for the coming year, showing provisions for payment of debt and interest. This information would be available if the accounting system provided the information described as necessary for the officers and council.

Summary of financial information required.—The financial information needed may be restated conveniently in outline form as follows:

Information regarding the financial condition of funds:

All the resources (cash, amounts receivable of various kinds, and inventories), all the liabilities and the various reserves.

From them the unappropriated surplus or the deficit may be determined.

Information regarding the financial condition of appropriations:

The amounts of the appropriations and the expenditures and encumbrances to date.

Information regarding current operations:

Income classified by fund, character, organization unit and source.

Cash receipts classified similarly.

Expenditures classified by fund, character, organization unit, activity and object, compared with appropriations and allotments.

Profits and losses of public utilities and other activities self-supporting in their nature.

Additional information used in budgeting:

Income, cash receipts and expenditures of previous, though recent, years. These are to be compared with current data and estimates for the present and coming years.

Details of the public debt.

Information for cost accounting:

Expenditures classified by organization unit, activity and object.

Stores accounting.

Depreciation of properties.

Miscellaneous:

Cash receipts and disbursements in sufficient detail to permit their verification and to show their relation to the proper funds.

Information for internal check in addition to cash verification, such as verification of amounts receivable, stores and amounts payable.

Unpredictable information for operating and other statistics.

Present Condition of Income and Expenditure Accounting for Municipalities

Enough similarity exists between municipalities to cause their needs for financial information to be much alike. It might therefore be expected that a considerable degree of uniformity would exist in the form of their financial reports.

That is not the case, however. A study of their reports discloses a surprising absence of uniformity and even a failure to fol-

low certain generally accepted accounting principles. Some cities report expenditures, while others report only disbursements. Some profess to report disbursements, but their statements clearly indicate that they are presenting expenditures; and conditions the reverse of this are also found. Some report their expenditures (or disbursements) classified by object of expenditure, some by activities and functions, some by the name of the vendor and some in other ways. Income is also diversely classified, and vague and widely varying terminology is used. The nature of the financial information best suited to municipal governing seems not to be well recognized.

It is difficult to determine the extent of uniformity existing in municipal accounting at the present time. Approximately one-half of the states have prepared and are recommending or requiring uniform systems of accounting for some or all of the municipalities within their borders. Furthermore, the classification of accounts used by the bureau of the census of the United States department of commerce in its financial statistics of cities has had a noticeable influence toward introducing uniformity in the accounting for cities of other states. Nevertheless, as between states and within the states which do not foster uniform systems, there is a conspicuous lack of uniformity in the recording and reporting of income and expenditures.

To illustrate the lack of uniformity the following data were taken from the reports of thirteen cities having a population between 100,000 and 150,000 (1930 census). By choosing cities of approximately equal size, any differences which might arise in the accounts through variations in the population should have been avoided.

Dissimilar funds.—Each of the cities reported a division of income and expenditures between funds, but the funds ranged in number from four to seventy-one. Furthermore, there was comparatively little similarity between them. Each city had one fund dealing with general income and operating expenditures, but such funds were designated in various ways (general fund, current fund accounts, current accounts corporate fund, or no title at all) and varied widely in their scope.

Differing treatment of capital expenditures.—Capital expenditures were clearly separated from operating expenditures in only six of the thirteen reports. In two of the reports no distinction was drawn between the two classes of expenditures. In the re-

maining five reports, it seemed impossible to determine whether the separation was made or not. Good accounting, of course, requires that the separation be clearly made.

Varying classification within the funds.—All of the thirteen cities classified the expenditures (or disbursements) within most of their funds, but they were far from uniform in their method of classifying. Six cities distinguished between certain character classes—operation expenses, fixed charges, capital outlays, etc.; all of them reported by departments; ten showed, to some extent, the items segregated by functions and activities; and twelve had a form of object classification. But as the fund classifications were quite incomparable, so these classifications within the funds followed no common rule or tendency. In one report a classification would be made subsidiary to another; in another report they held reversed positions. Sometimes their positions were reversed in different parts of the same report.

Income (or receipts) was classified within the funds with much more uniformity—the prevailing method was by character and by source. Usually the character classes were not identified, apart from the sources, but they could be readily determined.

Differing bases of accounting.—In most of the thirteen reports it was impossible to determine whether the figures presented were merely receipts and disbursements (cash accounting) or revenues and expenditures (accrual accounting). The titles given to the tables of accounting information were too contradictory to give conclusive evidence.

Even when the cash terms "receipts" and "disbursements" were consistently used in a report, the reader usually could not feel satisfied that the figures represented only cash transactions. When balance-sheets were presented in the reports (a common occurrence) they seemed always to include taxes receivable and accounts payable or encumbrances, indications that accrued items were recorded in the accounts. Yet reconciliations between the figures purporting to be cash and the accrued items seem never to have been offered.

At the present time we see widespread agitation for uniformity and improved methods of accounting for municipalities. It is timely, therefore, to have ready for use a model system of accounting, or any essential part thereof, suitable to the present financial requirements of municipalities.

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

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

EXAMINATION IN AUDITING

November 14, 1935, 9 A. M. to 12:30 P. M.

The candidate must answer the first nine questions and either question 10 or question 11.

No. 1 (5 points):

How should receivables representing accounts due in instalments maturing later than one year after date of the balance-sheet be shown on a statement prepared for seeking a three months' loan from a bank? Give your reasons.

Answer:

In a merchandising business, two methods may be followed.

Instalment accounts in a finance company are generally shown in one amount in the balance-sheet supported by a schedule showing the monthly maturities. It is not common practice to make a distinction in the balance-sheet between current and other assets.

In a manufacturing or trading business, instalment accounts receivable may be shown as (1) current assets with a parenthetical note showing the amount of such accounts maturing beyond the year, or the (2) amount currently due may be shown as a current asset and the amount due after one year shown below the current asset caption. In either case, the reserves for losses should be shown separately as a deduction from the accounts.

For credit purposes, supporting schedules showing the monthly maturities of the receivables is most desirable.

No. 2 (15 points):

State briefly your understanding of the meaning in accountancy of the following terms:

Working fund
Fund balance-sheet of a municipality
Debenture
Escrow
Hypothecation
Depreciation
Obsolescence
Amortization.

Answer:

Debenture—A written obligation issued against the general credit of the company without any special security.

Escrow—A deposit in the hands of a third party for delivery upon the fulfilment of some condition, or for some other purpose.

The following are taken from *Accounting Terminology*, preliminary report of a special committee on terminology published under the auspices of the American Institute of Accountants.

Working fund—"Often funds supplied to branches to pay all disbursements, the total receipts of each branch being remitted to the head office. Such working funds are almost always imprest funds and are reimbursed in the same manner as other imprest funds. It is usual, however, for large purchases, especially of fixed assets, to be paid for directly by the home office, not out of the working fund. This fund, indeed, is intended to do what its name implies, namely, supply funds for the working of the enterprise, not for its establishment or extension."

Fund balance-sheet of a municipality—"(1) A balance-sheet which sets forth the assets and liabilities of a particular fund, e.g., sinking fund, corporate stock fund, trust fund.

"This form of balance-sheet is used chiefly for municipal operations and when so used shows the funding relations of a city, or other political subdivision, containing on the credit side unexpended authorizations to incur liabilities, contingent liabilities on contracts and orders, reserves for retirement of temporary loans, etc., and on the debit side resources available for meeting them, such as cash not otherwise applied, outstanding taxes available and the amount of other revenue which a city or other political subdivision has pledged itself to collect."

Hypothecation—"The deposit of any securities or property as a pledge for the payment of a debt."

Depreciation—"Depreciation is loss in physical or functional value of physical property, other than wasting assets, due primarily and chiefly to ordinary wear and tear which has occurred theoretically in the past and is not offset by adequate repairs and/or replacements."

Obsolescence—"The basic idea conveyed by this word is that of becoming out-of-date or falling into disuse.

"It is usually applied to plant and equipment which, although in good physical condition, has become old-fashioned through the progress of invention or advance in the arts, so that results are achieved more efficiently and/or at less cost under new methods.

"Obsolescence may be caused by the cessation of demand for the particular articles for the production of which a plant or unit was constructed or installed. This element of loss would be eliminated if the plant or unit could be readily converted to other use."

Amortization—"The basic idea suggested by this word is that of reducing, redeeming or liquidating the amount of an account already in existence.

"In finance and accounting this word means the gradual extinguishment of an asset, a liability or a nominal account by prorating the amount of it over the period during which it will exist or its benefit will be realized.

"Amortization is caused by and the computations are based upon effluxion of time or units of production. Life of a right or obligation or loss of possession or use are the governing factors, e.g., amortization of a patent or of debt discount and expense, or of a bonus paid for a lease, or of the value of machinery, buildings, etc., on leasehold property which revert

to the landlord upon expiration of a lease, or of the value of mine equipment whose useful life is known to exceed the productive life of the mine and is necessarily to be abandoned upon ceasing operations.

"Amortization is also used to denote the gradual extinguishment of a debt by means of a sinking fund."

No. 3 (5 points):

In a detailed audit you find that the item "deferred charges," shown in one aggregate amount on the balance-sheet, comprises discounts on financing, deferred development, advertising and sundry operating expenses. How will you treat this in your report?

Answer:

The deferred charges should be analyzed and segregated as to kind. The source from which they arose should be examined, the purpose of the expense and the method of amortization should be checked. Full comment on the expenses should be made in the audit report.

The deferred development expense and the deferred advertising expenses should be checked particularly to ascertain whether the products to which they apply are still being manufactured and sold, or whether they apply to products to be manufactured and sold in some future period. The basis of amortization is important and should be carefully verified. If the product is no longer being produced or sold, the expense applicable to the discontinued items should be segregated and written off, if possible to determine the amount.

The sundry operating expenses should be broken down into a more detailed classification, if practicable.

No. 4 (5 points):

Entering upon the audit of the A B Corporation you discover that in accordance with its usual custom it has held open its books for fifteen days after the end of its fiscal year and has entered, as of the closing date of said year, the collections of open accounts and cheques drawn in payment of purchase and expense bills, bearing dates prior to the end of the year. No other transactions during the fifteen days are so entered.

Discuss the probable reason for and the effect of this procedure, and state what action you would take in the matter. Give your reasons.

Answer:

The client probably wishes to improve his cash position, and also realizes that an equal reduction in the current assets and the current liabilities will improve the current ratio, even though the actual working capital may not be affected except for the discounts allowed and the discounts earned. If the discounts earned are more or less than those allowed, the statement of earnings (and net worth) will also be affected.

The accountant can not agree to this method of window dressing, and should adjust the accounts receivable, accounts payable, cash, and discount accounts to the balances as at the balance-sheet date. His balance-sheet should show the true condition of the business as at the date of the balance-sheet as closely as he can determine it to be; the reader of the statement accepts, in faith, that it is everything that it purports to be, a true statement of condition as at the date shown.

If comparative statements are rendered, the comparative figures should be adjusted also.

No. 5 (5 points):
In the accounts-payable item on the balance-sheet accountants rarely segregate those past due. Do you think this should be done? Give your reasons, pro and con.

Answer:

It is not the general practice to segregate the past due accounts payable items in the balance-sheet, inasmuch as all of the past due payables and those due within the current period are shown as current liabilities. The ratio of current assets to current liabilities will indicate, to a large degree, the ability of the company to meet its current obligations.

If any unusual situation is disclosed, such as a particularly large amount of long past due accounts, such fact should be shown in the balance-sheet.

No. 6 (10 points):
The A B Corporation offers you an engagement to make a detailed audit of its books and accounts, your fee to be paid in stock of the corporation at par. For some time the stock has been quoted above par on the local exchange.
State whether or not you would accept such an engagement, and why.

Answer:

I would not accept the engagement subject to payment in the listed stock of the company because I might be charged with rendering a report which would influence the market price of the stock which I was to receive. The possibility of being biased in the auditing of accounts of a company in which the accountant is a stockholder, even though remote, is always present.

The company's officials should have no objection to selling the stock to obtain the amount of the fee.

No. 7 (15 points):
Describe how you would proceed in the audit of a bank to verify (a) cash on hand and in other banks amounting to $2,000,000; (b) the collateral loans; and (c) the bank's own investments.

Answer:

The auditor should maintain control of all of the cash, cash items, and negotiable instruments until he has completed his audit of such items. This may be accomplished by distributing the staff and making the various cash counts and security verifications simultaneously, or by placing the securities under seal while the cash is being counted. Representatives of the bank should be required to be in attendance with all members of the accountant's staff.

(a) Cash on hand and other banks:

All cash should be counted; bundles of bills and rolls of coins should be tested. All cash and clearing items, cheques, money orders, etc., should be forwarded for clearing under the control of the auditor, and should be followed up to see that the proceeds have been credited to the account of the bank. The amount due from banks should be verified by requesting confirmations from all of the banks, together with statements of the client bank account from the date of the last statement to the date of the audit, so that all transit items may be accounted for. The statements should then be reconciled with the ledger accounts.

(b) Collateral loans:

The notes should be examined for formality and negotiability; signatures and endorsements on the larger items should be compared with the

signatures on record. Notes discounted, or out for collection, should be confirmed. All of the collateral indicated by the register should be located, examined and evaluated. The collateral should be examined to ascertain that it has been endorsed or is accompanied by a power of attorney. Demand loans long outstanding, and past due time loans (even though secured by collateral) should be examined to determine whether a reserve for loss is required. Amounts due from officers and directors should be shown separately.

(c) Bank's own investments:

To facilitate the inspection and count of the bank's own investments, it would be well to prepare schedules from the books and records before commencing the audit of the investments. All of the securities should be counted and inspected and checked against the prepared schedule. This schedule should contain a complete description and classification, including the purchase date, maturity date, interest rate, interest dates, par value, cost, market value, dividend rates, dividend dates, etc. All stocks and registered bonds should be in the name of the client bank; all coupon bonds should have the future coupons attached. The accrued interest should be computed. Any securities not on hand should be noted and verified by confirmations from the custodians. In addition, all of the documents—bonds, title guarantee, fire insurance policies, etc.,—accompanying mortgages owned by the bank should be inspected. Interest income should be traced through the cash records, and the accrued interest computed. Past due and defaulted mortgages and bonds should be considered with a bank official and a reserve for loss should be set up. Consideration should also be given to providing a reserve against any decline in the market value of the securities.

No. 8 (20 points):

The X Corporation desiring additional capital submits to an investment company a statement in which the "net income for 1934 available for dividends" is shown as $65,000.

You are engaged by the investment company to audit the books of the X Corporation for the purpose of verifying this net income. Your audit discloses the following facts which are not shown in the statement, viz.:

(a) Depreciation for the year amounting to $16,000 was not provided;
(b) Dividends of $25,000 on preferred stock were payable on the day following the date of the statement;
(c) A machine manufactured by the corporation for its own use at a cost of $12,000 was charged to machinery account at the market price of similar machines, namely, $17,000;
(d) In accordance with the terms of a trust deed under a bond issue $15,000 should have been credited out of net income to a sinking fund reserve;
(e) There was included in the net income $12,000 derived from non-recurring transactions apart from the usual business operations;
(f) No provision was made for the 1934 federal income tax.

Explain how each item should have been treated on the books or on the statement, and prepare summaries showing (a) the correct net earnings and (b) the net income available for dividends.

Answer:

(a) Depreciation is an operating expense; the provision of $16,000 for the year should be charged against profit and loss and credited to the reserve for depreciation account.

(b) The dividends of $25,000 on preferred stock payable the following day, while not a charge against operating income, should be shown as a current liability in the balance-sheet. The charge should be made against surplus account.

(c) It is a well-known accounting principle that profits may be earned only on sales to outsiders; a saving is not a profit. When the company charged its machinery account $17,000 for the machine which cost $12,000 to construct, it produced no profit. The saving of $5,000 should have been credited to an unrealized profit account, and not to earnings (which action is assumed).

(d) The provision for the setting aside of $15,000 from earnings (under the trust indenture) reduces the amount available for dividends, but does not reduce the amount of the current year's earnings.

(e) Accountants are not in agreement concerning the treatment of so-called non-recurring credits; theoretically, such credits should be made directly to the surplus accounts, and not considered as a part of operating income. However, as the profit was realized, it is available for dividends.

(f) Provision for the federal income tax on the current year's profits should be made. As shown in the following statement, the taxable income is $44,000. As the rate is 13¾ per cent., the liability for such tax is (13¾ per cent. of $44,000) $6,050. This amount should be deducted in arriving at the amount available for dividends.

(a) Statement showing the correct earnings.

Net income as reported		$65,000
Deduct:		
Provision for depreciation	$16,000	
Eliminate saving treated as a profit	5,000	21,000
Net income, before provision for federal income taxes		$44,000
Deduct: federal income taxes		6,050
Net income		$37,950

(b) Statement showing the net income available for dividends.

Net income as reported		$65,000
Deduct:		
Provision for depreciation	$16,000	
Eliminate saving treated as a profit	5,000	
Provision for federal income tax	6,050	27,050
Net income available for dividends, before provision for sinking fund		$37,950
Sinking-fund provision		15,000
Net income available for dividends		$22,950

No. 9 (10 points):

A corporation has been in business for many years and both business and plant facilities have been continually expanded. It has regularly made good

profits and accumulated a large surplus which is shown without explanation on the balance-sheet as a single item.

At an annual meeting the stockholders complain that their dividends have not been commensurate with the prosperity of the corporation as shown by the annual statements, and the president explains vaguely that while most of the surplus is legally available for dividends, there are practical reasons why it can not be distributed at the present time. Not satisfied with this explanation the stockholders thereupon engage you to make an examination and analysis of the surplus account and report thereon.

Assuming that the president's explanation is correct, state what you would expect to discover and report.

Answer:

If the explanation of the president "that . . . most of the surplus is legally available for dividends" is true, I would expect to find that the surplus profits have been reinvested in plant additions. My report would cover this point, stating that while the company had a surplus account, the funds were applied to the purchase of additional plant facilities, and consequently were not on hand for the payment of dividends. A statement of application of funds would be included as a part of my report.

It is also possible that certain restrictions on the payment of dividends may have been made in the provisions for a bond or preferred stock issue; that the surplus was created by a write-up of values; that the surplus account, is in fact, a paid-in or capital surplus not legally available for dividends. If so, I would obtain an opinion of the company's attorney as to the legality of the declaration of dividends, from these sources, and comment fully upon my findings in the report.

No. 10 (10 points):

In 1914 the A Corporation leased property consisting of land, buildings erected thereon and machinery installed therein to the B Corporation for 99 years. Inter alia the lease provided that the property should be returned to the lessor at the termination of the lease in as good condition as when leased and also that any improvements made by the lessee should become the property of the lessor upon termination of the lease.

In 1924 the lessee made extensive additions to the buildings and also scrapped some of the machinery, replacing it with modern equipment at a greater cost than that of the original units leased.

In 1934 the lease was terminated by breach and the lessor came into possession of the property.

What is the federal-income-tax status of the A Corporation in 1934 in respect to

(a) the additions to the buildings and
(b) the improvements to the machinery

made by the B Corporation?

Explain your answers.

Answer:

"If buildings are erected or improvements made by a lessee and such buildings or improvements immediately become the property of the lessor, as, for instance, if they are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon any one of the following bases:

(a) The lessor may report as income for the taxable year in which such buildings or improvements are completed their fair market value at the time of their completion.

(b) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(c) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has reported income upon basis (a), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor shall report income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included." Regulations 86, article 22 (a)—13.

From the above it will be seen that the lessor has a choice of one of three different bases from which to choose in reporting the income. In the year 1934, unless the corporation reported on basis (a), the taxpayer should include as income the value of the additions erected by the lessee to the extent that the value of such additions to the buildings exceeds the amount already reported. In the case of the machinery, the corporation should report as income, the value of the new machinery to the extent that the value of such new machinery at the date of the termination of the lease exceeded the value of the old machinery had the old machinery not been replaced.

No. 11 (10 points):

What are the general advantages of monthly balance-sheets, profit-and-loss and operating statements (a) if prepared by the bookkeeper and (b) if prepared or audited by a public accountant?

Answer:

While the cost of having the monthly statements prepared by a public accountant will be higher than if the statements were prepared by the bookkeeper, the following should be considered:

(1) The accountant is better trained and has had a broader experience to draw upon.

(2) Suggestions relative to the system of internal check and its operation can be offered immediately.

(3) The opinion and the suggestions of the accountant are unbiased.

(4) The fact that the statements were being prepared by the accountant would probably minimize the possibility of fraud or embezzlement.

(5) The accountant would be available immediately to analyze and confer on the statements.

(6) The latest statements would be available for certification should the client need them.

Examination in Accounting Theory and Practice—Part I

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

A correspondent has called attention to the following points regarding the solution of problem No. 2, which was published in the *Students' Department* in the January, 1936, issue of The Journal of Accountancy.

"(1) Concerning the transfer of $50,000 from current funds to endowment funds, although the loan is indicated as temporary in character, the amount represented by it is not available in current funds for expenditure. Consequently, it is believed that it should be set up in an endowment fund as 'funds temporarily functioning as endowment' and should not appear in current funds or that a reserve should be set up for it under current funds so as to segregate it from the surplus of those funds. In line with these suggestions, the balance-sheets of general current funds, endowment funds, and funds invested in plant would appear as per the appended statement. Balance-sheets of other funds would not be different from THE JOURNAL OF ACCOUNTANCY solution.

"(2) Although the governing board of the college might have authority to make an outright expenditure of $100,000 for a residence hall from undesignated funds functioning as endowment, it is believed that, since a residence hall is an income producing enterprise, the item should be shown as an investment of endowment funds and not as a reduction in them. This would modify the balance-sheet of endowment funds and of funds invested in plant.

"(3) The problem calls for 'a statement of current income, expenditure and surplus' and it would seem that this might be met by such a statement as is appended. In this statement the orders and contracts outstanding at the end of the year are not included under expenditures but are shown as an amount reserved from surplus at the close of the year." (See next page.)

Statement of income and expenditure
and current funds surplus

Income:		
Educational and general		$1,070,000
Auxiliary enterprises		315,000
Non-educational income		15,000
Total income		1,400,000
Expenditures:		
Educational and general	$1,060,000	
Auxiliary enterprises	252,000	
Non-educational expense	26,000	
Total expenditures		$1,338,000
Net excess of income over expenditures		62,000
Balance, beginning of year		86,000
Add:		
Transfer from annuity funds		1,000
		$ 149,000
Deduct:		
General funds transferred to plant funds	$ 62,000	
Transfer to endowment	50,000	
Reserve for encumbrances	6,000	118,000
Balance, end of year		$ 31,000

Balance-sheet (part)

Assets

Current funds:			
General—			
Cash		$18,000	
Investments		20,000	
Accounts receivable		3,000	
Inventories		18,000	
Total general		$59,000	
Endowment and other non-expendable funds:			
Cash		$ 3,000	
Investments—			
Securities	$857,000		
Institutional property (in which endowment funds are invested)	100,000	957,000	
Funds in trust		100,000	$1,060,000
Funds invested in plant:			
Educational plant (total)	$3,442,000		
Less: investment of endowment funds in institutional property	100,000	$3,342,000	

Liabilities, reserves, and surplus

Current funds:			
General—			
Accounts payable		$ 2,000	
Reserve for encumbrances		6,000	
Working capital		20,000	
Unappropriated surplus		31,000	
Total general		$59,000	
Endowment and other non-expendable funds:			
Endowment funds, principal	$ 810,000		
Undesignated funds functioning as endowment	250,000		$1,060,000
Funds invested in plant:			
Bonds payable	$ 100,000		
Net investment in plant	3,242,000		

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