

BULLETIN No. 1

DECEMBER, 1924

THE
KENTUCKY SOCIETY
OF
CERTIFIED
PUBLIC ACCOUNTANTS
INCORPORATED

COMPLIMENTS

... OF ...

JNO. C. McNEIL
CERTIFIED PUBLIC ACCOUNTANT
(KENTUCKY—OKLAHOMA—NORTH CAROLINA)

MAIN
1936

ASSOCIATE MEMBER
EUGENE S. HOWARD & CO.
AUDITORS AND ACCOUNTANTS

CITY
1238

1615-1616 INTER-SOUTHERN BLDG.,

LOUISVILLE, KY.

FOREWORD.

When the word "accountant" is uttered there immediately occurs to a great many people a mental picture of an old grey headed man sitting on a high stool and bending over a ledger, pen behind ear, ink wells scattered around over his desk and a great litter of paper on the floor near the waste basket.

Probably the main reason for this attitude on the part of a very large portion of the public is the fact that thru untold ages the accountants work was limited almost exclusively to keeping records, was more or less mere drudgery and regarded as a necessary evil.

Within comparatively recent years there has been a wonderful evolution in the profession of accountancy, the same as there has been in all other professions, and today the certified public accountant sits side by side with the engineer and attorney at the council tables of modern business organizations.

The work of the Certified Public Accountant is that of helpfulness and assistance rather than of direction. His is the work of helping to organize the modern business concern, helping to finance it, devising such accounting schemes and methods as may be best suited to the particular business, finding costs, evaluating the work of employees, analyzing and comparing statistics and presenting to the management such data as will help to make the business venture successful and profitable.

It is with a view of helping disabuse the public mind of the old idea and creating a new point of view that this little booklet has been prepared.

Succeeding issues will be published every little while.

Respectfully,

THE KENTUCKY SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS.

December, 1924

THE BALANCE SHEET.

That the Balance Sheet presents a picture of the financial condition of the business at a stated time, is well known. But it is doubtful if the business man realizes the completeness of the picture. The Balance Sheet, with its accompanying schedules, prepared by the Certified Public Accountant, makes sure that the completeness of the picture is visible to the reader. We believe that a brief discussion of the method of presentation of Balance Sheets as approved by the Kentucky Society of Certified Public Accountants will be of interest to the Banker, the Credit man, the Investor and the Management of Business.

The usual readers of Balance Sheets as enumerated above, have, perhaps, widely different motives in their analysis of the Balance Sheet but the well presented Balance Sheet gives to each the information desired. It is doubtful if a standard terminology or a standard grouping of the items on a Balance Sheet is possible or desirable, but the account names will clearly indicate the nature of the accounts, and their position on the Balance Sheet will further show their kind. It might be further stated that for each particular business, conditions require some change from a probable standardized form. Everyone realizes that a Balance Sheet may be misleading although every figure thereon be correct, but we do not believe everyone appreciates the extent to which information may be misstated. The Certified Public Accountant realizes that the value of his financial statements lies in the true information that business men may read out of them. Therefore, to this end, he follows certain general rules which he applies specifically to each particular business in order that his Balance Sheet may show truly the financial structure of that business.

The first consideration is the proper classification and grouping of the accounts so that the amount of capital in each class of assets and liabilities may be readily noted. The accounts in each group which are characteristic of the business are set out in order that they may be noted in the analysis. The basis for the valuation of the assets and exact character of the liabilities are most clearly shown. Such a grouping will give us, generally, a form in which the current or liquid assets are set opposite the current liabilities, the fixed or permanent assets opposite the long termed indebtedness and net worth. Each item is ordinarily listed with reference to its liquidity. Such general form must, as we have explained, be fitted to the particular case at

hand in order that it will offer the information and give the comparisons enumerated in the following paragraphs. Some of the detailed information will necessarily come from supporting schedules and from the Profit and Loss Statement.

The capital with which business is carried on or the working capital position of the company is clearly set forth. This, of course, is determined from the current assets and liabilities, the difference between them being the working capital of the business. Comparative Balance Sheets, or the balance sheet for the beginning and end of the period, give the change in the working capital position as a result of operations, and a detailed analysis of this change reflects a large part of the operating history of the business. The ratio of the current assets to current liabilities is an index to the condition of solvency of the business and a favorable ratio is essential to a good credit position.

The capital in which, or the house in which the business is carried on is represented in the fixed or permanent assets. The value of the fixed assets, from the standpoint of management, is not their possible sales value, but the value obtained from their use. So that the fact to read from the Balance Sheet is the relation of value of the fixed assets to sales and volume of production. Careful study of fixed property expense to the total cost of doing business will play a large part in planning for the extension of the plant. An analysis on such a basis would have saved many businesses from over expansion during the late war period.

An analysis of the liabilities which are grouped into, current, fixed or long term indebtedness, and net worth, shows the source from which the assets come. Further, and of more importance, an analysis will disclose the most economical method of obtaining the money necessary to furnish the working capital and carry the permanent or fixed investments.

As may be seen, the comparisons and relationships involving every item on the balance sheet give valuable information. The relationship between Accounts Receivable and sales expressed in the number of day's sales carried in accounts receivable points out the fact that the more nearly this figure approaches the credit terms the higher is the percentage of net profits to net worth, which is the relationship of most importance and interest. Likewise the inventory turnover can be shown to have its direct effect on the percentage of net profit. This same thing is true of all other relationships as they relate to the final

percentage of net profit. The effect of any change in the structure of the business as shown by its Balance Sheet is directly traceable in its effect on earnings. The other important relationship that expresses a summing up of all the other relations is the percentage of net profits on sales or volume of business. This percentage will be the result of conditions, favorable or unfavorable that will be disclosed by an analysis of the individual items making up our Balance Sheet.

From the standpoint of the management, or those operating the business, the important final relationship is the percentage of operating net profit to the total capital employed in operating the business. This measure applied further to the operating departments or units of the business discloses whether or not each unit of the business is earning a fair return on the capital used by it.

In the financial management of the business, the analysis of Balance Sheet as to the source from which the capital is derived, the cost of borrowed capital, and the turnover of total capital employed, gives information of importance. The percentage of net profits necessary to be left in the business in order to properly finance it, is readily determined.

Our Balance Sheet has, then shown the banker and the credit man, the information they seek from it, the working capital position and the basis of the valuation of the assets and the exact character of the liabilities. The investor and the management of the business are interested in those items and more particularly in the earning power and the reasons that have contributed to it. We have said that the Certified Public Accountant knows that the value of his statement lies in the information that business men read out of them. We hope that this article has shown some part of the information that the Certified Public Accountant labors to put into his Balance Sheets that it may be plainly read and that a service of untold value may be rendered to business.

TAXATION.

THE REVENUE ACT OF 1924

The law under which income taxes for the year 1924 will be computed was enacted on June 2nd, effective as of January 1, 1924.

The normal tax rates on individuals were reduced about twenty-five per cent and there has been a material reduction in the individual surtax rates, but the twelve and one-half per cent tax on net incomes of corporations remains unchanged.

As a large part of the active, productive business of the country is conducted under the corporate form, such business will continue to bear the brunt of the tax burden.

"Earned income" up to the maximum amount of Ten Thousand Dollars is subject to an additional reduction of twenty-five per cent. By reason of this concession to individuals on "earned income" it may be that numerous small corporations could minimize their tax burden by changing to the partnership form of doing business. Any such change should be given careful consideration and all phases of the situation carefully weighed, as some of the most complicated cases now confronting the Treasury Department are the result of hasty dissolutions of corporations effected in 1919 and 1920. Counsel and advice in matters of this kind from a competent Certified Public Accountant will be cheap at any price.

The corporate form of doing business has many advantages over the partnership or individual business concern and where the income fluctuates from year to year, or where net losses are suffered in some years, the corporate form may effect the larger saving in taxes.

Aside from the changes in rates with which the general public is now fairly familiar, the Revenue Act of 1924 makes some rather noteworthy departures from prior acts in its definitive and administrative provisions.

The definitions covering gain and loss have been written under a scheme of cross references that would surely appeal to any student of the modern cross word puzzle. I believe this section of the law has been attributed to the Treasury Department direct, and the draftsman in trying to cover specifically every conceivable transaction thru which taxable income could be derived, has possibly unwittingly disclosed direct avenues thru which taxation may be avoided.

It would seem the Revenue Department has contracted for innumerable controversies over what constitutes "earned income." Section 209 specifically defines "earned income" as wages, salaries, professional fees and compensation for personal service and in cases where both personal services and capital are material income producing factors the law provides for a *reasonable allowance* for the personal service actually rendered but not exceeding twenty per cent of the net profits. I have in mind a taxpayer who purchased an old building for Twenty Thousand Dollars, has spent the major part of his working hours during the past eighteen months remodeling the building at a cost of about Forty Thousand Dollars and has sold the property for Seventy-five Thousand Dollars. Of course his total taxable profit is Fifteen Thousand Dollars, but what part of it constitutes "earned income?" A strict interpretation of the law will say only Three Thousand Dollars for his eighteen months of hard work. Prior to his engagement in the construction of this particular building this same taxpayer enjoyed an annual salary of Ten Thousand Dollars, and to now convince him that he has *earned* only Three Thousand Dollars in eighteen months, in spite of his visible profit of Fifteen Thousand Dollars, is going to take considerable persuasive powers.

Net losses have been better defined than in prior acts, but a loss on the sale of capital assets, even though connected with the trade or business, appears to have been eliminated from the classes of losses that may be carried forward to offset future profits.

The provision relating to capital net gains and losses has been amplified but does not appear to have been materially simplified.

Depletion on discovery value of mineral properties has been reduced to fifty per cent of the net income from the property as computed without the benefit of this deduction. Depletion and depreciation on costs remain unchanged.

Those who are expecting refunds on prior year taxes will welcome the new provision of law providing for interest on the refund from the time the tax was originally paid. Likewise additional assessments will include interest from the time the tax was originally due until the time it is paid. The interest will be calculated by the Collector at the time of certifying the refund or collecting the additional tax.

In the event an extension of time is granted in which to file any return, the tax due under such return will bear interest from the origi-

nal due date until the end of the extension asked for, even though the return be filed and the tax paid before the expiration of the extension. This is a radical departure from prior acts, and if any considerable amount is involved care should be exercised when asking for an extension to carefully estimate the correct time for which such extension should be granted. In this connection it is to be noted that the power to grant extensions of time in which to file returns has been taken entirely out of the hands of Collectors and now is vested solely in the Commissioner of Internal Revenue and that requests for extensions must be received by the Commissioner prior to the expiration of the time in which the return becomes due under the statute. Power to grant extensions for thirty days for sickness or absence has heretofore been vested in Collectors, and this change in procedure will probably work considerable hardship to a number of taxpayers who, for various reasons, are delayed in the preparation and filing of their returns.

Another radical change in the law is the practical abolishment of claims in abatement.

Heretofore some taxpayers have waited until a tax was assessed before consulting an accountant in regard to the liability, and it was then necessary to file a claim in abatement and have the Tax Unit make a complete review of the whole case. Hereafter no claims in abatement may be filed except where the so called jeopardy assessment has been made by the Commissioner without giving the taxpayer an opportunity to first appeal the case.

This brings us to the newly created United States Board of Tax Appeals which is probably the outstanding feature of the Revenue Act of 1924 and is an unique experiment in appellate tribunals. The law provides for a Board of seven members except that until June 2, 1926, the Board shall be composed of such number of members, not exceeding twenty-eight, as the President determines to be necessary. The President has made recess appointments of twelve members and the Board has been functioning since early in September. It has so far decided about fifty cases and has pending a very congested docket. Having a tax tribunal slightly less formal than the courts, which is separate from the Treasury Department, is highly desirable. Its effect upon the Treasury Department itself should be beneficial because the Department will have to justify its decision before the Board before a taxpayer shall be required to pay. It is to be hoped that it will tend to lead the Department to settle cases in the first instance on a basis that

will be fair to the Government and the taxpayer and thus protect against the congestion before the Tax Board which otherwise will surely result.

The Board has jurisdiction only in cases of a deficiency in tax determined by the Commissioner after June 2nd, 1924. It has no jurisdiction in claims for refund or credit, and neither has it jurisdiction in cases of deficiencies assessed prior to June 2nd, 1924. In this connection it is to be noted that an assessment is made when the Commissioner of Internal Revenue signs the assessment list and certifies the same to the Collector. This may be and often is several months after the return is filed.

Inspection of tax returns and all data relating thereto may be made by the Commissioner or any one properly authorized to act for him at any time and as often as he may deem necessary. When an examination is made by an Internal Revenue Agent his report is submitted to the Agent-in-charge and the taxpayer is furnished a copy. The taxpayer then has the privilege of submitting a protest to the Revenue Agent-in-charge in an endeavor to reach an agreement upon any controverted questions of fact or law. In the event the taxpayer and Revenue Agent-in-charge cannot reach an agreement the papers are then forwarded to the Income Tax Unit in Washington. After the Income Tax Unit has reviewed the case and given the taxpayer proper time for conference and discussion of the matter, the taxpayer is notified of the findings by registered mail and given sixty days in which to appeal to the United States Board of Tax Appeals. If the Board's decision is favorable to the Government the taxpayer's remedy lies thru payment of the tax under protest and then suit in the Federal Courts for refund. If the Board's decision is favorable to the taxpayer then the Government's remedy lies in a suit in the Federal Courts for payment of the tax.

Only attorneys-at-law and Certified Public Accountants may represent a taxpayer before the Board of Tax Appeals.

The Revenue Act of 1924 deals, of course, with a great many different kinds of taxes besides income, but it would seem that at this season of the year the income tax is of paramount importance and I have therefore confined my observations to this feature of the law.

It is submitted that income tax, in theory, is the fairest and most equitable manner of raising needful revenue to defray the expenses

of government for the simple reason that it places the burden upon the ability to pay. So long as it is in effect it will necessarily be complicated in both computation and administration for the reason that economists cannot agree on what constitutes income. The theory of income tax reverts to prehistoric times, but its broad practical application is of comparatively recent growth.

Being a theoretical concept it must necessarily be complex and its complexity has been greatly magnified thru a multiplicity of laws within a very few years. There will eventually be evolved a simpler and more easily understood law, but until that time comes the man of affairs can well afford to depend upon the counsel and advice such as the Certified Public Accountant is qualified to give.

It is an old adage handed down by the legal profession that "he who argues his own case has a fool for a lawyer."

The saying might well be extended to state that "he who computes his own taxes values highly his own time."

THE VALUE OF AUDITS.

A much quoted definition of an Audit begins "An Audit is a verification of the *accuracy* of books of Account." Audits are then subdivided generally into two kinds, Balance Sheet Audit and Detailed Audits, the difference between the two classes being, mainly, the degree to which the detail is checked. Certainly such a definition does not reflect more than a small fraction of the value, to Business, of Audits. To the majority of business men the word "accuracy," in the definition, means clerical accuracy alone, but to those who understand the entire meaning and implication of the term, a far larger significance is conveyed by its use in this connection.

This article will attempt, briefly, to give an idea of the values offered and the results obtained through the Audits conducted by Certified Public Accountants, as sanctioned by the Kentucky Society of Certified Public Accountants. Theory and technique will have no place in our discussion. On the contrary, we shall attempt to bring out the "dollars and cents" value, by which Business measures service, with the hope that a definition of "Auditing" will, in the future, be evolved that will clearly set forth the whole service rendered by Audits.

Our prospective client tells us, "Our books of account are in splendid shape and my report, as president, or general manager, gives statements of our business condition that I know are correct. But the owners or directors are not in active touch with the business and it's worth it to me and to them, to have your Certified Report." Or else he tells us, "We're not satisfied with our records. Not that anything is radically wrong, but whereas in all operating departments we know exactly where we stand, in our bookkeeping, we're never up to date and sometimes we doubt the accuracy of our records. We're worried about it and we want an Audit."

The conditions mentioned above seem to the prospective client to justify the classes of Audits that are commonly known as, in the first case, a Balance Sheet Audit and in the second, a Detailed Audit, and are the general reasons that bring, perhaps, a majority of clients to our offices.

But as we shall show, the value he expects to receive is the smallest fraction of the value he will receive from our Audit. Let us detail briefly our ordinary procedure in the making of an Audit. With-

out any attempt at logical technical sequence, the procedure is about as follows:

1. Collection of data as to current conditions affecting client's type of industry and the particular conditions affecting the client's individual business.
2. Study of the peculiarities and capabilities of client's employees.
3. Study of the system of internal check, or in other words see how far the work of one employee is complementary to that of another, thus checking one another.
4. "Verification of the accuracy of the books of account," which of course, includes the analysis of the accounts which make up the assets and liabilities asuring the further accuracy of the amounts which reflect the true financial condition of the business.

This procedure has put the Accountant in such a position that, now, by a further analysis he can present the information that goes to make up the major part of the value of his Audit report.

The presentation of the results of this final analysis depends of course, upon the method of analysis used, and it would not be of interest here to discuss the merits of the different possible methods. In the main, they arrive at the same result.

The Balance Sheet will present a picture of the financial position of the business at a certain date. It answers two principal questions: 1. How much money is invested in the business and in what manner? 2. From what source was that money obtained? A Balance Sheet at the beginning and at the end of the period answers the two additional major questions that logically suggest themselves. 1st. What new money came into the business and from what source? 2nd. In what manner was this money invested in the Business?

We have then presented a picture of the business at the beginning and end of the period, and a statement of the change in financial position. All other schedules attached support the items shown on the current Balance Sheet, or give the detail of the change in financial position.

The Income Statement or the Profit and Loss Statement is of course the principal statement giving a detail of the change in financial position. A complete picture can only be obtained by considering the Balance Sheet and the Income Statement together.

In addition to answering the four general questions above, the Audit report will apply those measures of business efficiency which

may be applied to the fundamental business relationships. That there is an ideal proportionate relationship between every item on the Balance Sheet, for each type of Industry, is well known. Furthermore any variation from this ideal affects, favorably or unfavorably, the cost of doing business and also affects the net profit for the period. The most important of these relationships are: Measures of Earnings and Measures of Costs and Expenses.

Measures of Earnings are:

- The relation of net profits to net worth.
- The relation of net profits to volume of business.
- The relation of operating profits to total capital used.
- The relation of operating profits to volume of business.
- The relation of gross earnings to volume of business.

Measures of Costs and Expenses are:

- The relation of costs and expenses to volume of business.
- The cost of borrowed capital.
- The cost of total capital employed.

Other important ratios are the working capital ratio and the proportion of earnings left in the business. In addition are the turnover ratios,—on inventories, accounts receivable, fixed property investment, and total capital employed.

These relationships presented comparatively with those of other periods of the life of the business, and considered in connection with the known data of similar concerns in the same industry, will give information pointing to remedies that will reduce costs and increase profits.

We have not touched on the value of our Audits as regards the comments contained therein on the adequacy of the client's accounting system, nor the psychological effect on the employee's work. These values are obvious as is also the value of the detached standpoint from which the auditor views conditions. To the official who has been, perhaps, too close to his business, the Auditor's viewpoint is of great value in determining future methods of management.

Such an Audit certainly deserves a better definition than our usual one, and our qualifying terms "Balance Sheet Audit" and "Detailed Audit" can only qualify a more complete definition by indicating the degree to which the detail transactions are checked. However, we

have a qualifying term, "Continuous Audit" that means, not only continuous auditing throughout the accounting period, but the presentation, usually monthly, of reports, and the complete service possible through auditing, at the time when such information is of use in the current period. It is by means of the "Continuous Audit" that the Accountant is able to offer his greatest service to Business. There is no condition under which such service cannot show direct results in "dollars and cents." There is no Business so small that it cannot afford and profit by such service, and likewise no Business so large that such service is not of value greatly in excess of its cost. An Accounting paper says, "For every business having an annual audit, these days, there are twenty using Continuous Audits." That statement is hardly based on facts, in this territory at least, but it certainly states a fact that will be true a few years hence. There is no greater service than can be rendered by Certified Public Accountants through Continuous Audits.

IMPORTANT TAX DATES FOR 1925.

February 1st	Last day to file State Corporation License Tax return.
February 10th	Last day 3 per cent discount allowed on City (Louisville) taxes.
March 15th	Last day to file Federal Income Tax return and pay first installment of tax.
June 15th	Last day to pay second installment Federal Income Tax.
June 30th	Last day to pay City (Louisville) tax to avoid penalty.
July 31st	Last day to file Federal Capital Stock Tax return.
September 15th	Last day to pay third installment of Federal Income Tax.
October 1st	Last day to file State and County Tax return to avoid arbitrary assessment.
October 15th	Last day to file City (Louisville) tax return to avoid arbitrary assessment.
December 15th	Last day to pay fourth installment Federal Income Tax.
December 31st	Last day to pay State and County taxes to avoid penalty.

THE UNITED STATES BOARD OF TAX APPEALS

Recognizes Certified Public Accountants.

"RULE 2.—ADMISSION TO PRACTICE."

"The following classes of persons may be admitted to practice before the Board:

- "(a) Attorneys at law who are admitted to practice before the Supreme Court of the United States, or the highest court of any State or Territory, or the District of Columbia.
- "(b) Certified Public Accountants duly qualified under the law of any State or Territory, or the District of Columbia."

MEMBERS.

ALEXANDER, J. W.	CLEVELAND, OHIO
BERNSTEIN, BENHARD	LOUISVILLE, KY.
BERNSTEIN, SYLVAIN K.	LOUISVILLE, KY.
BRADFORD, J. W. R.	CINCINNATI, OHIO
CAMERON, JAMES	NEW YORK, N. Y.
CLACK, B. R.	TULSA, OKLA.
CONLEY, E. C.	HUNTINGTON, W. VA.
COTTON, WM.	LOUISVILLE, KY.
DECKEBACH, FRANK C.	CINCINNATI, OHIO
ESKEW, S. W.	LOUISVILLE, KY.
GREEN, HARRY W.	CINCINNATI, OHIO
HIFNER, W. A. JR.	LEXINGTON, KY.
HOWSON, H. M.	LOUISVILLE, KY.
IMHOF, IRVIN W.	LOUISVILLE, KY.
KAASE, C. E.	CLEVELAND, OHIO
KALMBACHER, JOSEPH R.	BINGHAMPTON, N. Y.
KNAPP, JESSE	PORTSMOUTH, OHIO
MAYES, J. R.	LOUISVILLE, KY.
MORRISON, R. E.	CINCINNATI, OHIO
McBRIDE, M. J.	LOUISVILLE, KY.
McGLASSON, R. S.	LOUISVILLE, KY.
McMULLEN, M. B.	LOUISVILLE, KY.
McNIEL, JOHN C.	LOUISVILLE, KY.
PHAGAN, K. B.	NEW YORK, N. Y.
QUINN, D. W., JR.	DAYTON, OHIO
RICHEY, HOBART	WHEELING, W. VA.
ROUSE, ROBT. B.	CINCINNATI, OHIO
SEWARD, F. A.	HUNTINGTON, W. VA.
WILLISON, FRANK H.	PITTSBURGH, PA.
WOLF, WALTHER	SAN FRANCISCO, CAL.
WRIGHT, C. C.	CINCINNATI, OHIO
YOUTSEY, J. H.	DAYTON, OHIO

*32 Total
12 Ky*

