

Q. What is the name of it?

A. Several preliminary books I wrote prior to the publication of a textbook referred to as Beginning Accounting, which was published in 1940.

Q. Where is this book used?

A. It was used in several schools and colleges throughout the country.

Q. Was it used at the University of Nebraska?

A. Yes, it was.

Q. Of what professional societies are you a member?

A. The American Accounting Association, the National Association of Accountants, American Association of University Professors, the Interprofessional Institute.

Q. What is your educational background?

A. I took my first degree at the University of Nebraska, A. B. degree, in February of 1915. At the same time thereafter I started to teach accounting and went on to take my Masters Degree in June of 1916, then went on to Columbia University to continue my advanced courses, but I never did go on and take any further degrees.

Q. Have you ever testified in court as an expert accounting witness before?

A. Yes.

Q. In what court have you testified?

A. In this Court, the Tax Court, the local Federal Courts, Nebraska Courts and the Federal District Court.

Q. Have you examined the books of the partnership, Arthur Murray Dance Studio?

A. Yes, I haven't audited them but I have examined them, looked at them, I never made an audit of them.

Q. Have you read the Stipulation of Facts and the exhibits attached thereto in this case?

A. Yes.

[fol. 190] Q. Have you seen the other exhibits introduced in evidence?

A. Yes.

Q. Have you been in the courtroom and heard the evidence given so far in this case?

A. Yes.

Q. What other information would you need in order to form an opinion as to whether the books and records of

a partnership are maintained under generally accepted and sound accounting principles?

A. I think none other than what I have seen.

Q. In your opinion, are the books and records of the partnership maintained in accordance with generally accepted and sound accounting principles?

A. Yes, I think they are.

Q. Specifically, with reference to the item known as deferred income on the books, has this item been handled in accordance with generally accepted and sound accounting principles?

A. Yes, it has.

Q. Why, in your opinion, has this item known as deferred income been handled in accordance with generally accepted and sound accounting principles?

A. Well, it's certainly improper to take into income any item of income until it's earned and wrong to take in theoretical records of income or statistical records of income until that income has actually been produced and I think that is the way these books have been kept. They do record income as it is earned and not until it's earned. These books, while they have reflected a memorandum of agreement to do certain things, they have not recorded any income earned by those agreements. They have recorded a memorandum that they have perhaps created a liability but they haven't recorded any record of the fact they have earned any income at the time the contracts were entered into so I don't think there is any income in those recorded receivables at the time they are recorded and there is no income there until the studio has delivered the service they contracted to give, and for that reason I think that there is no income there until the Studio earned it and I think they have been accurately recorded as the income was earned at the time it was earned.

Q. In other words, you feel that the method of accounting employed by the partnership properly reflects its true income?

A. Yes, I do.

Q. Is the account receivables that are reflected at the [fol. 191] time the contract is entered into a true account receivable in the accrual accounting concept?

A. No, it isn't.

Q. Will you explain that?

A. All it is is a memorandum of agreement to do certain things. They record the contract that they are going to agree to deliver certain services in the future, having delivered none whatsoever at the time it is recorded on the records and it is only a memorandum of a certain type of agreement that has been entered into, and that is all you can say about the account. Actually a true account receivable is entered after the service has been rendered and not before. The ordinary concept of an account receivable or note receivable is when a firm accepts payment in that fashion for a service that has been rendered, and not what they intend to do at some time in the future.

Q. Does the adjustment made to deferred income by the Commissioner result in a determination of true income of the partnership?

Mr. McCormick: In your opinion.

By Mr. Bauersfeld:

Q. In your opinion.

A. I think it doesn't.

Q. Will you explain why not?

A. Because it brings into income a record of income before any of it has been produced, at least before all of it has been produced, that while there are some cases where cash may have been collected at the time of the record made that cash that is on hand is not true and in fact is a trust fund that is on hand in this account and which they are duty bound to spend in the rendering of that future service and accountants would look at it as a true trust fund that has to be kept on hand. It reflects a liability in income on this concern to spend funds and perform in the future.

Q. Now, as a practicing public accountant could you or would you certify to a financial statement prepared under the Commissioner's method of determining income?

A. I certainly would not.

Q. And why would you not?

A. I think if an accountant would certify that those so-called items of deferred income represent net worth he would be making a false report to the banks or others [fol. 192] concerning their financial liability to carry on. If it's net worth it's there to be drawn out. If it's a corporation it's in its dividends or if it's a partnership it's there representing funds that may be drawn out for personal use and it would be a violation of their liabilities and contractual relations to their customers if that were true and it would misinform the bank concerning their ability to carry on as a growing concern and perform their business daily transacted or required to be carried on by them and I think no accountant would certify to the accuracy of a statement that did not contain these items as deferred income, either subtracted from the assets or as an inclusion in the liabilities.

Q. Would you certify to a financial statement with some qualification that was prepared under the Commissioner's method of determination?

A. No, sir, I would not. We don't prepare certified statements with qualifications.

Mr. Bauersfeld: You may inquire.

The Court: Cross-examine.

Cross examination.

By Mr. McCormick:

Q. Mr. Cole, are you a certified public accountant?

A. No, sir.

Q. You spoke of your opinion about these funds being a trust fund, are you a lawyer?

A. No, sir.

Q. With respect to your many long years of teaching, Mr. Cole, would you say that you have been pretty successful in your teaching?

A. Oh, yes.

Q. Without bragging too much.

A. I see several of my students sitting around here. They seem to be doing pretty well, and at least I've stayed with it for quite a while.

Q. Are you familiar with the fact one of the students you just referred to has been doing pretty well in the accounting field, who set up this case for the Government?

A. I always considered Mr. Berry one of my very good students. We didn't always agree, but he was a good student.

Q. In your teaching you recognize and you mentioned you teach tax accounting?

A. Yes.

[fol. 193] Q. You recognize there are many differences in tax accounting and commercial accounting?

A. Yes, I do. There are a good many places where they differ.

Mr. McCormick: I believe that's all.

Redirect examination.

By Mr. Bauersfeld:

Q. Mr. Cole, did you ever take the certified public accountant examinations?

A. No, I never did.

Mr. Bauersfeld: No further questions.

The Court: All right, Mr. Cole. Thank you, sir.

(Witness excused.)

Mr. Bauersfeld: May Mr. Cole be excused, Your Honor?

The Court: Yes, he may be excused.

Mr. Bauersfeld: I will call Mr. Miller.

Whereupon, JAMES D. MILLER, called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

Direct examination.

The Clerk: Would you be seated and state your name and your address, please.

The Witness: James D. Miller, Bronxville, New York.

By Mr. Bauersfeld:

Q. Mr. Miller, what is your occupation?

A. I am a certified public accountant.

Q. How long have you been a practicing public accountant?

A. About 37 years.

Q. What is the name of your firm?

A. James D. Miller & Company.

Q. How many people are employed by your firm?

A. Well, it varies from year to year and in the course of the year it will range from 20 to 50.

[fol. 194] Q. What territory does your practice encompass?

A. Our offices are located in New York City. However, our work takes us all over the country and into some foreign countries.

Q. Have you ever performed any professional services for the United States Government?

A. Yes, I have.

Q. Will you tell us what they were?

A. During World War II we audited a portion of the President's unvouchered funds; we were also retained by the Office of Strategic Services to do all of the accounting work in connection with the renegotiation of War contracts, contract termination and cost-plus contracts and price readjustment.

Q. Now, over the period of years what has been the nature of your accounting practice?

A. Well, we have done all kinds of accounting practice, that is all types of accounting services that a certified public accountant would in the ordinary course of events be called upon to do. However, we have specialized in tax practice and in special investigations.

Q. What is your educational background?

A. I graduated from a small country high school. From there I went to preparatory school by the name of Franklin Marshall Academy. After graduating there I went on to the University of Pennsylvania. After World War I I found I needed some accounting training in the job I had at that time so I went to night school and studied account-

ing in Pace & Pace Institute. After that I took special accounting courses at Columbia University, New York University, and City College of New York. That's all.

Q. Do you belong to any professional associations or societies?

A. Yes, I do.

Q. Which are they?

A. The New York State Society of Certified Public Accountants, the American Institute of Certified Public Accountants.

Q. Have you ever testified in court as an expert accounting witness?

A. Yes.

Q. Will you tell us the Court and the names of some of the cases in which you have been retained to testify?

A. We were retained a little over 20 years ago to do all of the accounting work and testify in the so-called Madison Anti-trust case at Madison, Wisconsin. In that case the [fol. 195] Government had brought an anti-trust action against all 22 major oil companies operating throughout the mid-western area of the United States. I testified in that case not only for the collective defendants but also for many of the individual oil companies. There were two Madison cases and we were also retained to do the accounting work and testify in the second Madison anti-trust suit. That was followed shortly after by an anti-trust action brought by the Government against all of the eight major oil companies operating on the Pacific Coast and also about 50 independent oil companies and we were retained to do all accounting work and testify in that anti-trust action.

The six major oil companies operating in the State of Wisconsin became defendants in a large triple-damage suit, conspiracy suit, and we were retained by them to do the accounting work in the suit and testify in that case.

In the anti-trust suit brought by the Government against the eight major motion-picture companies I testified in that suit.

We were also retained in other anti-trust actions. One was against the Corrugated & Solid Fiber Shipping Container Industry. We were retained to testify in the triple-damage suit brought against Ford Motor Company by

Harry Ferguson, Inc., and others. That was a \$350,000.00 action. We did accounting work for the Ford Motor Company in that case. We worked for the Ford Motor Company and testified in other suits brought against them. For instance, the All-Tight Motor Products Co., Inc., brought a triple-damage suit against them for \$10,000,000.00. We retained to testify in the triple-damage suits brought against the cigarette companies, the American Tobacco Company and Liggett & Myers. There was a \$36,000,000.00 action brought against them by the Monticello Tobacco Company. I testified for the Pathe Film Company in an accounting suit against E. I. Dupont de Nemours. I testified in a triple-damage suit brought by the Interborough News Company against Curtis Publishing Company and seven other large magazine publishers. I testified for Borg-Warner Corporation in a case brought by them against the Government of the United States in the Court of Claims. I testified in quite a few accounting suits, for instance in connection with the dissolution of the theatrical firm of Klaw & Erlanger, also [fol. 196] in a suit arising out of the liquidation of a large export and import firm by the name of Crossman & Sielkes.

In another suit in Pittsburgh, brought by the Julian Kennedy Coal Industries against the Hellman Coal & Coke Company. I am testifying now in a suit in connection with the partition of the theatrical firm of Lee and J. J. Shubert. I testified before the Interstate Commerce Commission in connection with the merger of the Chesapeake & Ohio Railroad and the Pere Marquette Railroad.

We were retained to do accounting work and testify in the Bendix Aviation Corporation stockholders derivative suit. We were retained in the anti-trust action in the Government conspiracy suit that was brought against the nine large manufacturers in the copper wire and cable industries. I was retained by various special prosecutors appointed under the Moreland Act in the State of New York in various investigations, one having to do with determining the costs and administration of the Workmen's Compensation Administration. I was retained to testify in the \$20,000,000.00 damage suit by the receivers for the Paramount-Public Corporation against its former manage-

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ment. I testified in an action brought by the Securities & Exchange Commission, against the former management of the Thermoid Company.

I have been retained to testify in a triple-damage suit brought against the Western Auto Supply Company down in South Carolina. I testified in a large number of tax cases. I testified in a case involving the Hall Scott Motor Car Company out in California, the Sylvania Industrial Corporation down in Virginia, the Welcome Wagon, Inc. down in Georgia and for some movie people out in California, such as Adolph Zukor, Jesse Lasky, and Harold Lloyd. I testified in Wilmington in another tax case for the American Bemberg Corporation and in Pittsburgh for the National Electric Products Corporation and out in South Bend, Indiana, for the C. G. Cohn Band Instrument Company. There are some more but I don't recall them off-hand.

Q. Well, I think that's enough, Mr. Miller. That's a pretty good list. Have you examined the books of the partnership Arthur Murray Dance Studios which are here involved?

A. Yes, I have.

[fol. 197] Q. Have you read the Stipulation of Facts and the exhibits attached thereto?

A. Yes.

Q. And the other exhibits which have been introduced.

A. Yes.

Q. Have you been in the courtroom and heard the testimony given so far in this case?

A. Yes.

Q. What other information would you need in order to form an opinion as to whether the books and records of the partnership Arthur Murray Dance Studios are maintained under generally accepted and sound accounting principles?

A. None other.

Q. Now, in your opinion are the books and records of the partnership maintained in accordance with generally accepted and sound accounting principles?

A. Yes.

Q. Now, specifically with reference to the item on the books known as deferred income, has this item been handled in accordance with generally accepted and sound accounting principles?

A. Yes, it has.

Q. Why do you say that this item known as deferred income has been handled in accordance with generally accepted and sound accounting principles?

A. Well, it's important to recognize at the outset what it represents. It's the amount of lessons that have been contracted for but have been untaught, at the end of the fiscal period. It represents what I consider merely a commitment or an intent on the part of the student to go through with his contract and to take those lessons at some future date. It has nothing to do with lessons that have already been taught. It has only to do with lessons yet to be taught. It's in a sense a backlog that these studios have for lessons to be taught in the future. The deferred income is represented by cash, that is cash advance payments on an executory contract to the extent that cash has been received, that there has been a deposit or it's backed up by receivables, merely memoranda receivables and in some cases there may have been a note which was discounted at the Bank. To the extent that it's offset, in fact it's entirely offset by either cash or memoranda receivables, the receivables as this business was conducted, apparently were not enforceable. There were very large cancellations. Cancellations amounted to in excess, over this five-year period, to 20 percent of the total sales. Now, that ratio would be much higher as to accounts receivable [fol. 198] or these memoranda receivables. I made a test over the five-year period and I found that the cancellations ran as high, they were equivalent to 67 percent of the accounts receivable or all receivables that were outstanding, and that statement applies to the beginning of each of these five fiscal years.

It is important to note, too, that there is no element of profit in this deferred income, this so-called deferred income. This is a liability reserve and while it's taken into account at the contract price of the sale, actually there is no element of profit in it because these Studios were teach-

ing at cost, they were teaching at cost and charging the students, simply what it cost them to render the tuition service. Their entire profit was limited to the income that was derived from cancellations and from transfers and a net interest earning, and small capital gains but the entire income of this enterprise throughout the five fiscal years is limited to just those elements. In other words, there was no operating profit at all in this business. In these years in question, at any rate, that is true.

Now, therefore, the entire balance in this deferred income account was simply a liability reserve. It would cost that much to render the service in a future fiscal period. Under those circumstances it was a proper accounting procedure to not take into account this deferred income into the profit-and-loss account until such time as the income was earned, that is when the teaching service was rendered and it would have been highly improper under an accrual method of accounting to take into account income without taking into account matching expenses. The proper accounting under accrual basis is to see that your expenses match your income and the expenses incurred by the teaching were to be rendered in a future fiscal period as far as all this deferred income was concerned. By the employment of this method used by this enterprise, income did not get, that is there was nothing taken into account in earned income until the service was rendered.

Q. You have referred to the memorandum accounts receivables, would you explain that as distinguished from a true account receivable?

A. Yes. A memorandum account receivable would be one that would be set up on the books in connection with [fol. 199] an executory contract, that is where something is to be done in the future when some product is to be shipped or supplied or a service is to be rendered in the future and it is set up; if it is ever set up in the books it is set up only for memorandum purposes and for the purpose of control. That would happen to be necessary in this particular situation. I think I could illustrate it best by taking the example that His Honor used this morning in connection with the sale of an automobile. A man can go into

an automobile agency and buy a car. When the car was delivered to him then you have a real accounts receivable, but if a man was to go into an automobile agency today and decide he wanted a 1959 model whenever he can get it, and perhaps that car has not been even manufactured yet but he is going to get that at some future date and he leaves an order for it, that is certainly a memorandum account receivable.

Q. That would be true even though he put a deposit on it?

A. That's right.

Q. Does the accounting method employed by the partnership Arthur Murray Dance Studio actually reflect its true income?

A. It does.

Mr. McCormick: In your opinion?

By Mr. Bauersfeld:

Q. In your opinion?

A. Yes.

Q. Does the system of accounting employed by the partnership bear a true relation to the services rendered and the costs to be incurred by the partnership?

A. It does.

Q. Does the adjustment made to deferred income by the Commissioner in the notices of deficiency in your opinion result in a determination of true income of the partnership?

A. No, it doesn't and on the contrary it results in a material distortion of income.

Q. Will you explain why it results, in your opinion, in a distortion of income?

A. As I said a moment ago, this deferred income was a liability reserve. It will cost this enterprise that full amount to render that service in the future. It has an obligation, a commitment, to give these lessons, and it must spend as much to render the service, render the tuition service, as it has set up in this deferred income account, and it would be highly improper not to match [fol. 200] that cost with that income. In my opinion the income isn't earned, it isn't realized until that service is ren-

dered and there is no matching of the income and the related expenses and you must have that to have a proper and a true and an accurate determination of income under the accrual basis.

Q. Do you know of any other accounting method that would truly reflect the partnership's income?

A. No, I don't, and I think that the system here used was ideally adapted to the necessities of this business and that it conformed with the customs of conducting this business. I think it was ideal in every respect.

Q. Do the tax returns of the partnership, which are in evidence, in your opinion properly or truly reflect its true income?

A. Yes, the tax returns are in conformity with the books. They have been, the books have been consistently maintained on this accounting basis ever since the organization of the enterprise back in 1946. There has been a consistent application of the accounting principles and the tax returns do follow the books.

Mr. Bauersfeld: You may inquire.

The Court: We'll recess now for 10 minutes.

(Recess.)

The Court: We will now proceed.

Mr. Bauersfeld: If the Court please, I have one or two more questions of Mr. Miller.

The Court: Yes. All right.

By Mr. Bauersfeld:

Q. What were the restrictions as to the use of the assets and the deferred-income account?

A. Well, there were several. First of all there was this escrow account that was maintained with Arthur Murray, Inc., the licensor, and pursuant to the license agreement which required this concern to remit to it five percent of its tuition when received. Then there was a restriction also in connection with the so-called reserve account maintained with the Bank where students' notes were discounted with recourse. I think, too, that there is an inherent restriction as to use to a substantial extent in connection with the

[fol. 201] memorandum accounts receivable, in this respect that you are certainly restricted as to something you are not getting, you will never get it, and the experience of this enterprise has shown that 50 percent of the accounts receivable, the memorandum accounts receivable on the books at any one time will never be realized. As I said before, the cancellations of receivables have averaged 62 percent of the receivables that were outstanding at the beginning of each of these five years.

Mr. Bauersfeld: You may inquire.

The Court: Cross-examine.

Cross examination.

By Mr. McCormick:

Q. As I understand your testimony, Mr. Miller, it is to the effect that the books and records of this partnership reflect their proper income according to good commercial and theoretical accounting principles.

A. In accordance with sound accounting principles, that is, with generally accepted accounting practice, yes.

Q. You do realize there are many differences in commercial accounting and tax accounting do you not?

A. There are some.

Mr. McCormick: I believe that's all.

Redirect examination.

By Mr. Bauersfeld:

Q. In the phrasing of one of the questions on cross-examination, the phrase used was that in "commercial and theoretical principles". Did you mean to imply any of this was theoretical, Mr. Miller?

A. No, I think it's quite the contrary. I think it's very practical. It recognizes the necessities of this particular type of business and my answer was to the effect it's in accordance with sound accounting practices and generally recognized accounting practices.