

the original, extension or renewal type of sale. The lessons that are given to the student are recorded on the card and the date of each lesson and the teacher's name and the mere subtraction, of course, of the total hours to date from the total amount in the contract gives you the unused hours at any particular time. Also the card shows the date and the amount of each payment and the balance due on the course.

Mr. Bauersfeld: At this time I'd like to offer in evidence Petitioner's Exhibit No. 23.

Mr. McCormick: No objection.

The Court: It will be received in evidence, Petitioner's Exhibit No. 23.

(The card referred to, heretofore marked as Petitioner's Exhibit No. 23, for identification, was received in evidence as Petitioner's Exhibit No. 23.)

[fol. 149] By Mr. Bauersfeld:

Q. When a course is sold, what entries are made?

A. When a course is sold, the amount of the course is charged to the student, representing his obligation to pay the Studio and is credited to the deferred income account, representing the Studio's obligation to perform. At the same time the sale is entered into the general books of account a card is made and appropriate entries made thereon.

Q. When you refer to "Studio", in your testimony, you are referring to the partnership of Arthur Murray Dance Studios?

A. Yes, sir.

Q. By the way where are the books and records of the partnership maintained?

A. In my office.

Q. How is that partnership earned income finally determined at the end of the year?

A. Each course is completely analyzed as to the number of hours that were taught during the fiscal year. The rate per hour on that particular course and of course the amount of applicable earned income and all these courses are added and balanced and the total amount of earned income arrived at for the fiscal year and the books and records are adjusted to that analyzed figure.

Mr. Bauersfeld: I ask that this be marked as Petitioner's Exhibit No. 24.

The Court: It will be marked for identification as Petitioner's Exhibit No. 24.

(The schedule referred to was marked as Petitioner's Exhibit No. 24, for identification.)

By Mr. Bauersfeld:

Q. I hand you Petitioner's Exhibit No. 24, and ask you to identify it.

A. This is a schedule I prepared showing the transactions affecting contract amount of deferred income and relating untaught lessons and balances at the end of each fiscal year for the years ending March 31, 1950 through

March 31, 1954. It shows the total contract amount of deferred income outstanding at the beginning of each year, it shows the total contract amount of sales made during each fiscal year, it shows the total contract amount of [fol. 150] income transferred to earned income, the total amount of contracts transferred to earned income and the total contract amount earned and cancelled due to lack of activity and the contract balance of earned income at the end of each year. In addition to that, it shows the beginning number of untaught hours at the beginning of each fiscal year, the sales in hours made each year, the actual hours taught during each year and the actual number of hours cancelled each year and the balance of untaught hours at the end of each fiscal year.

Q. In effect this is a complete history of the deferred income account and the untaught hours?

A. That is right, this is a complete history of the deferred income account and the untaught hours for the entire five-year period.

Mr. Bauersfeld: I offer this document in evidence as Petitioner's Exhibit No. 24.

Mr. McCormick: It's a rather complicated schedule which we haven't seen, Your Honor.

The Court: May I see it, please?

Mr. Bauersfeld: Yes, sir.

The Court: I'm assuming that this now is a schedule, I'm reading now the title of it, "Schedule reflecting transactions affecting contract amount of deferred income and relating untaught hours and balances at the end of each fiscal year." Now, it's my understanding that the witness, who is a certified public accountant, has made this statement from the books that I take it are in the courtroom. Are they?

The Witness: Yes, sir.

The Court: And of course, the statement is that they are made up according to the way the accountant thinks they should be made up and the way that the petitioner contends is correct. That, of course, does not preclude the respondent from having some different theory and if he wishes to compile a similar statement for his theory it

might be he will do so. Whether it will, I don't know. But it seems to me this is an admissible document. It does not, of course, preclude the respondent from questioning [fol. 151] the method of it and arguing the method nor would it be binding upon the Court to accept it, but on the other hand it seems to me it is evidentiary of the very point that is in litigation in this case.

Mr. McCormick: Yes, sir. I don't suppose it would be possible to reserve objection until possible after lunch, until after I have had an opportunity to look at it?

The Court: You may make an objection at that time if you wish to state one and the Court will permit you to make one. I understand this has not been furnished to you before. It will be received as Petitioner's Exhibit No. 24, subject, however, to the right of the respondent to object to it if he sees fit to urge some objection. The Court again states this is just one exhibit or just one bit of evidence in the case which the Court permits because he is assured that the books and records are in the courtroom. Of course, they could not offer a statement of this kind unless the books and records are here. The exhibit received as Petitioner's Exhibit No. 24, and you may proceed.

(The schedule referred to, heretofore marked as Petitioner's Exhibit No. 24, for identification, was received in evidence as Petitioner's Exhibit No. 24.)

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**Schedule Reflecting Transactions Affecting Contract Amount
of Deferred Income and Related Untaught Hours
and Balances at the End of Each Fiscal Year.**

Arthur Murray Dance Studio—A Partnership.

	March 31, 1950	March 31, 1951	March 31, 1952	March 31, 1953	March 31, 1954
Contract Amount of Deferred Income					
Balance—Beginning	\$ 37,844.61	\$ 72,611.87	\$106,541.70	\$131,143.92	\$255,912.33
Additions During Year					
Contract Amount of Sales	185,933.56	201,133.00	235,596.68	130,293.65	152,949.70
	\$223,777.17	\$273,766.17	\$341,908.38	\$561,437.57	\$408,899.40
Deductions					
Contract Amount Transferred to Earned Income	\$119,385.14	\$10,596.74	\$143,949.63	\$243,277.46	\$325,266.97
Contract Amount Unearned and Cancelled Due to Lack of Activity	31,589.53	38,926.73	66,844.83	82,217.78	113,975.76
Total Deductions	\$151,165.67	\$175,523.47	\$210,794.46	\$325,495.24	\$439,242.73
Balance—Ending—of Contract Amount of Deferred Income	\$41.87	\$96,115.00	\$133,141.92	\$235,912.33	\$418,700.00
Untaught Hours					
Balance—Beginning	5,767	11,311	15,000	17,186	4,168
Additions					
Sales	27,215	28,142	28,900	52,649	50,250
	2,982	39,173	44,000	70,135	2,966
Deductions					
Hours Taught—Transferred to Earned Income	27,189	48,400	47,430	28,100	30,170
Hours Untaught—Cancelled Due to Inactivity	1,592	5,611	20,111	10,531	10,250
Total Deductions	21,641	24,382	26,580	38,631	40,420
Balance—Ending—of Untaught Hours	11,311	15,000	17,486	31,168	31,677

[fol. 153] By Mr. Bauersfeld:

Q. Does the partnership ever decrease the number of hours of a course after it is originally written for sale, a larger course?

A. Yes, sir, quite frequently it's necessary to rewrite a course for a smaller sum of money.

Q. How is this handled on the books of account when a course is reduced?

A. When a course is reduced in amount, the cancelled portion of the course is charged to deferred income, reducing the deferred-income account and credited to accounts receivable for the unpaid balance of the course and the gain or loss is computed thereon.

Q. What entries are made when a student fails to complete his lessons?

A. When a student fails to complete his lessons, the unearned portion of the contract is eliminated from the accounts and if there is any unpaid accounts receivable of course they are credited to accounts receivable and the gain or loss computed on the cancelled contracts.

Q. During the years here involved by stipulation, paragraph XII, it has been stipulated that income as reflected in the partnership's books and returns for the fiscal years ended March 31, 1950 and March 31, 1954, includes gains or cancellations of students contracts as follows, and then there are those listed. Is that what is taken into account at that time?

A. That's right, that is the gain of cancellations over costs.

Q. Were these cash refunds ever made on any course that was cancelled?

A. Yes, sir.

Q. How were they handled on the books?

A. They were also handled in the same procedure as a charge against deferred income and the applicable accounts receivable written off and the gain or loss determined at that time.

Mr. McCormick? Your Honor, I object to the last testimony and ask that it be stricken from the record as inconsistent with the stipulation of facts. The exhibits

attached to the stipulation of facts contain contracts which specifically state that no cash refunds will be allowed.

[fol. 154] The Court: Well, the contract might so provide but if cash refunds were actually made, for the purposes of the income tax law they are made and whatever effect they have I don't know. It may be that according to the contract he wasn't bound to make any refunds but nevertheless we certainly have terms of contracts that are frequently waived. I'll overrule the objection.

By Mr. Bauersfeld:

Q. How do you determine what contracts are to be adjusted for lack of student activity?

A. For bookkeeping purposes a contract is deemed to have sufficient lack of activity on it to warrant cancellation if there has been a lack of activity on the course for more than one year. At that time the contract would be written off the books if it didn't have any activity on it for a period of one year.

Q. What would be done with the income?

A. It would be taken into account immediately as a gain on cancellation of the course.

Q. Do Mr. and Mrs. Schlude work in the business?

A. Yes, sir, quite a bit.

Q. What do they do?

A. They supervise the entire operations of the Omaha, Lincoln, Sioux City and Grand Island schools, and are, of course, in the schools all the time, quite frequently even working on Sundays.

Q. Does that apply to both Mr. and Mrs. Schlude?

A. Yes, sir.

Q. How much of their time do they devote to the business?

A. I'd say all of their time.

Q. Does the partnership incur any expenses in giving a course of dancing instructions?

A. Yes, sir.

Q. What is the nature of the expenses?

A. Well, they incur instructors' salaries, other types of salaries, office salaries, advertising, royalties, music supplies, music cost, records, depreciation of teaching facilities, student parties, contests, travel and convention, rent,

heat, light, water and other occupancy expenses, insurance, taxes, professional services and other general expenses.

Q. Does the accounting system of the partnership, as [fol. 155] your opinion, properly reflect the true income of the partnership?

A. Yes, sir, and it is the only system that will reflect the true income of the partnership.

Q. Why do you say it is the only system that will properly reflect the true income of the partnership?

A. It is the only system that takes income into account when earned and the related costs and expenses in the period when incurred. In other words, it's necessary under the accrual system of accounting to deduct from the income earned the cost and expenses incurred to produce that income. To take income into account for one period and the costs and expenses for another period does not properly reflect the true income. Under the actual system of accounting by the taxpayer the income is taken into account when earned and the costs and expenses in the same period so there is a true matching of expense against income so the true income can be determined.

Q. Would not you get the same result by accruing the costs and expenses against the income received?

A. No, sir. In order to compute the costs and expenses against the income received would require a great deal of estimation on the part of the accountant or bookkeeper to set up those costs on the books to offset income received. Under this system of accounting income is deferred until the costs and expenses incurred to produce that income are recorded on the books. In other words, there is nothing left to speculation, we wait until we have the known factors involved before computing the net income.

Q. Have the tax returns been prepared in accordance with the method of accounting regularly employed by the partnership in keeping the books?

A. Yes, sir.

Q. Has the system you installed in 1946 been used consistently over the years?

A. Yes, sir.

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. Yes, sir, there is a true relationship. Income is taken into account when the actual hours of instructions are given to the student and it is on the basis of the actual hours of instruction that the teachers are paid their [fol. 156] compensation. Other instruction costs are taken into account during the period which are applicable to the earned income, such as teachers' salaries, teaching supplies, depreciation of teaching facilities, student parties, and the rent and occupational expenses, taxes and insurance in connection therewith and all other instructional costs are taken into account during the period that the income is taken into account and therefore there is a direct relationship between the income reported and the services actually performed by the partnership and the cost of those services.

Q. In other words, there is no artificial or allocation of costs or expenses involved in this case?

A. No, sir.

Q. Did the partnership, during the taxable years of 1950, 1952, 1953 and 1954, have sufficient assets to cover all their liabilities in their deferred income?

A. Yes, sir, more than a sufficient amount.

Mr. Bauerfeld: We ask that this be marked as Petitioner's Exhibit No. 25.

The Court: It will be marked for identification as Petitioner's Exhibit No. 25.

(The schedule referred to was marked as Petitioner's Exhibit No. 25, for identification.)

By Mr. Bauerfeld:

Q. I hand you Petitioner's Exhibit No. 25 and ask you to identify it, please.

A. This is a schedule I prepared reflecting the excess of assets over liabilities at the end of each fiscal year, March 31, 1950, through March 31, 1954. It shows the total assets, cash, loans and miscellaneous receivables, investments, the Arthur Murray escrow fund, fixed assets and other assets as compared against liabilities and deferred income. In each case, for each year, there were excess assets over liabilities and deferred income and, in fact, if you take the cash amounts alone with the Arthur