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PRINCIPLES OF ACCOUNTING
ADVANCED

PRENTICE-HALL ACCOUNTING SERIES

H. A. Finney, Editor

PRINCIPLES OF ACCOUNTING ADVANCED

by

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PREFACE

IT IS now somewhat more than ten years since the publication of the first edition of *Principles of Accounting*. Those familiar with the original edition will find that, in the present revision, the sequence of subjects has been considerably changed; the treatment of several subjects has been amplified; certain other subjects, many of which are now dealt with in the author's *Principles of Accounting, Introductory*, have been omitted, or the space devoted to them has been reduced; and all problems and questions have been allocated to the chapters to which they primarily pertain.

Grateful recognition is here given to those who have taught from the original edition and who responded to the author's request for suggestions as to this revision.

If the names of persons or companies in this book bear any similarity to those of actual persons or companies, the similarity is fortuitous.

H. A. FINNEY

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PRINCIPLES OF ACCOUNTING
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CHAPTER 31

PARTNERSHIPS

Organization

Definitions.—"A partnership," as defined by the Uniform Partnership Act, "is an association of two or more persons to carry on, as co-owners, a business for profit."

A partnership may be spoken of as a firm, but it should not be called a company, as the latter term applies only to corporations.

A joint stock company is a partnership, the capital interests of which are represented by transferable shares. Joint stock companies may be organized in some states under the common law, and in others under special statutes governing their organization and operation.

In a limited partnership, the limited partners have no personal liability to creditors, but they must maintain their investments at the amounts stipulated at the time of organization. There must be at least one general partner who is liable to creditors for debts which cannot be paid from the firm assets. Limited partnerships are not permissible in all states.

Articles of partnership.—The partnership relation is based on a contract between the partners. This contract may be either express or implied.

If two or more persons actually engage in business together as co-owners without making an express agreement, orally or in writing, the law implies a contract, and a partnership exists. It is advisable, however, that the contract be reduced to writing and signed by the partners, so that disputes may be avoided so far as possible. It is desirable that the articles of partnership contain express agreements on the following matters:

The names of the partners, and the name of the partnership.

The date on which the partnership contract takes effect.

The nature and place of business.

The capital to be contributed by each partner; any interest charges to be made for failure to contribute the agreed amounts; and the treatment (as capital or loan) of any contributions in excess of the agreed amounts.

Any division of authority among the partners, if such division of authority is desired.

The dates on which profits or losses are to be computed, and the method to be followed in dividing them.

The drawings or salaries to be allowed. A clear statement should be made regarding the disposition of the partners' Drawing or Salary accounts, so that there can be no dispute as to whether such accounts are to be closed to Profit and Loss or to the respective Capital accounts.

The length of time the partnership is to continue, and an agreement concerning the method of liquidating the partnership at the termination of the agreed time. It is also advisable to include an agreement covering the contingency of a partner's death. This agreement should stipulate when and how the deceased partner's interest in the capital should be computed and paid to his estate, and whether any allowance should be made for goodwill. Similar provisions may be made with respect to a partner's retirement.

It may also be desirable to provide for the selection of arbitrators to whom the partners may submit disputes which they themselves are unable to settle.

Division of Profits

Closing the books.—The net profits shown by the Profit and Loss account should be transferred to the partners' accounts. There is no Surplus account on the books of a partnership. Such an account is unnecessary because each partner has an account to which his share of the profits may be credited. Moreover, it would be unwise to use a Surplus account and thus defer the division of profits, because, if the profit and loss ratio changed from one period to another, the Surplus account would contain accumulated profits divisible in different ratios.

The Profit and Loss account and the partners' Drawing accounts may be closed by various methods, as outlined below:

- (A) Close the Profit and Loss account to the partners' Drawing accounts.

In favor of this method, it may be said that drawings are assumed to be made against accruing profits; if the profits are closed to the Drawing accounts, each partner's Drawing account will show whether he has drawn more or less than his share of the profit.

After the Profit and Loss account is closed to the Drawing accounts, the disposition of the Drawing accounts should depend upon whether the partners have agreed to maintain fixed capital investments.

- (1) If there is an agreement with respect to fixed capital investments, and if:
 - (a) A partner is keeping the agreed amount at the credit of his Capital account, a credit balance in his Drawing account (representing the undrawn portion of his share of the profit) may be left in the Drawing account. But if:
 - (b) A partner is not keeping the agreed amount at the credit of his Capital account, enough of the credit balance in his Drawing account should be transferred to his Capital account to make good the impairment of capital; and a debit balance in the Drawing account should be transferred in full to the Capital account, to reflect the further impairment of capital.
- (2) If there is no agreement with respect to fixed capital investments, debit or credit balances in the Drawing accounts may be closed to the Capital accounts in order that the Capital account balances will show the partners' net investments at the end of the period.

PARTNERSHIPS

- (B) Close the Profit and Loss account to the partners' Capital accounts, and close the Drawing accounts to the respective Capital accounts.

This method has the advantage of showing in one account all of the changes in the partners' capitals resulting from investments, drawings, profits, and losses. However, it is not a desirable method for use in a partnership in which a distinction is to be made between fixed capital investments and undrawn balances of profits.

Bases of division of profits.—If the partners make no agreement regarding the method of dividing profits, the law provides that the profits shall be divided equally, regardless of any differences in capital investments, business ability, or time devoted to the business. The partners may, however, make any agreement they wish. Some of the customary methods of dividing profits are:

- (1) Equally.
- (2) In an arbitrary ratio.
- (3) In the capital ratio.
- (4) In the average capital ratio.
- (5) By allowing interest on capitals and dividing the remaining profit in an agreed ratio.
- (6) By allowing salaries to the partners and dividing the remaining profit in an agreed ratio.

Equal division.—Assume that *A* and *B* make a profit of \$11,484.00, and that it is to be divided equally, either because of an agreement to that effect or because of a failure to make any agreement. Each will be credited with \$5,742.00.

Arbitrary ratio.—Arbitrary ratios are usually expressed in terms of fractions or per cents. If the profits of \$11,484.00 are to be divided in the ratio of two fifths to *A* and three fifths to *B*, the division will be as follows:

Summary of Division of Profit		
<u>Partner</u>	<u>Ratio</u>	<u>Amount</u>
<i>A</i>	$\frac{2}{5}$	\$ 4,593.60
<i>B</i>	$\frac{3}{5}$	6,890.40
Total.....		<u>\$11,484.00</u>

It is sometimes agreed that a portion of the profits shall be divided in one ratio and the remainder in another. To illustrate, assume that the first \$8,000.00 of profit is to be divided in the ratio of two fifths to *A* and three fifths to *B*, and that the profits in excess of \$8,000.00 are to be divided equally. The division should be made as follows:

Summary of Division of Profit

	<u>A</u>	<u>B</u>	<u>Together</u>
First \$8,000.00 in ratio of $\frac{2}{5}$ and $\frac{3}{5}$	\$3,200.00	\$4,800.00	\$ 8,000.00
Remainder equally	1,742.00	1,742.00	3,484.00
Total	<u>\$4,942.00</u>	<u>\$6,542.00</u>	<u>\$11,484.00</u>

Capital ratio.—If partners desire to divide their profits in the capital ratio, they should have a definite agreement as to whether the ratio at the beginning of the period or the ratio at the end of the period is to govern. Otherwise, disputes may arise because investments and drawings during the period may change the capital ratio.

To illustrate, assume that *A* and *B* invested \$10,000.00 and \$20,000.00, respectively, on January 1; that each partner was permitted to draw \$200.00 per month against accruing profits, to be charged to his Drawing account; and that drawings in excess of that amount were to be charged to the Capital accounts. The following accounts show the original investments, the additional investments, and the drawings in excess of \$200.00 per month.

<u>A, Capital</u>		<u>B, Capital</u>	
Feb. 1 100	Jan. 1 . . . 10,000	Mar. 1 300	Jan. 1 20,000
Aug. 1 500	Sept. 1 . . . 2,000	Aug. 1 200	July 1 4,000
Nov. 1 200		Sept. 1 300	

The profits for the year were \$11,484.00.

If it was agreed that the profits were to be divided in the ratio of the capitals at the beginning of the year, the division should be as follows:

Summary of Division of Profit

<u>Partner</u>	<u>Opening Capital Balance</u>	<u>Ratio</u>	<u>Profit</u>
<i>A</i>	\$10,000.00	$\frac{1}{5}$	\$ 3,828.00
<i>B</i>	20,000.00	$\frac{2}{5}$	7,656.00
Total			<u>\$11,484.00</u>

If the profits were to be divided in the ratio of the capitals at the end of the year, the division should be as follows:

Summary of Division of Profit

Partner	Closing Capital Balance	Ratio	Profit
A.....	\$11,200.00	$11\frac{2}{3}\frac{44}{44}$	\$ 3,738.98
B.....	23,200.00	$23\frac{2}{3}\frac{44}{44}$	7,745.02
Total.....			\$11,484.00

Average capital ratio.—If partners agree to divide the profits in a capital ratio, it is presumably because they believe that their shares in the profits should be proportionate to the capital contributions furnished for the use of the business during the period. Obviously, neither the capital balances at the beginning of the period nor those at the end represent the capital used by the business during the period. To be entirely fair, consideration should be given not only to the amounts of the balances but also to the time during which the balances remained invested. This may be accomplished by dividing the profits in the average capital ratio.

When the average capital ratio is used, the partners should have an agreement regarding the amount of drawings which each partner is to be allowed. These agreed drawings should be charged to the Drawing accounts, and any drawings in excess of the agreed amounts should be charged to the Capital accounts, as they should affect the computation of the average capital ratio.

The average capital ratio may be computed by either of two methods.

First method.—

Multiply each partner's contributions by the number of months (or days) from the date of the contribution to the end of the period.

Add these products.

Multiply each partner's withdrawals (charged to capital) by the number of months (or days) from the date of the withdrawal to the end of the period.

Add these products.

Deduct the withdrawal products from the contribution products.

Divide the profits in the ratio of the resulting balances.

For purposes of illustration, we may use the Capital accounts of *A* and *B* appearing in the preceding section. Following is the computation of the average capital ratio, and a statement of the division of the profit.

Computation of Average Capital Ratio						
		Months				
		to				
	Date	Amount	Dec. 31	Products	Sum of Products	Balances
A, Capital:						
Credits:	Jan. 1	10,000.00	12	120,000.00		
	Sept. 1	2,000 00	4	8,000.00	128,000 00	
Debits:	Feb. 1	100.00	11	1,100.00		
	Aug. 1	500 00	5	2,500 00		
	Nov. 1	200.00	2	400.00	4,000.00	124,000.00
B, Capital:						
Credits:	Jan. 1	20,000.00	12	240,000.00		
	July 1	4,000.00	6	24,000.00	264,000.00	
Debits:	Mar. 1	300.00	10	3,000.00		
	Aug. 1	200 00	5	1,000 00		
	Sept. 1	300.00	4	1,200.00	5,200 00	258,800.00
	Total					<u>382,800.00</u>

Division of Profit		
Partner	Fraction	Profits
A.....	1240/3828	\$ 3,720.00
B.....	2588/3828	7,764.00
Total.....		<u>\$11,484 00</u>

The preceding computation determines the *ratio* between the average capitals, but it does not determine the average capitals. To compute the average capitals, it would be necessary to divide each of the two balances by 12, thus:

$$A: \$124,000.00 \div 12 = \$10,333.33, \text{ Average capital}$$

$$B: 258,800.00 \div 12 = 21,566.67, \quad \text{ " } \quad \text{ "}$$

The division by 12 is useless, however, because all that is required is the ratio between the average capitals, not the average capitals themselves. The ratio between \$124,000.00 and \$258,800.00 is the same as the ratio between \$10,333.33 and \$21,566.67. In fact, the division by 12 is worse than useless, because the fractions 1240/3828 and 2588/3828 are more easily dealt with than the fractions 10,333.33/31,900.00 and 21,566.67/31,900.00.

Second method.—

Multiply each new capital account balance (resulting

PARTNERSHIPS

from an investment or a withdrawal) by the number of months or days the balance remained unchanged.

Find the sum of these products.

Divide the profits in the ratio of these sums.

Computation of Average Capital Ratio

	<u>Date</u>	<u>Debits</u>	<u>Credits</u>	<u>Balance</u>	<u>Time</u> <u>Unchanged</u>	<u>Products</u>
A, Capital:	Jan. 1		10,000.00	10,000.00	1 mo.	10,000.00
	Feb. 1	100.00		9,900.00	6 mos.	59,400.00
	Aug. 1	500.00		9,400.00	1 mo.	9,400.00
	Sept. 1		2,000.00	11,400.00	2 mos.	22,800.00
	Nov. 1	200.00		11,200.00	2 mos.	22,400.00
	Total				12 mos.	124,000.00
B, Capital:	Jan. 1		20,000.00	20,000.00	2 mos.	40,000.00
	Mar. 1	300.00		19,700.00	4 mos.	78,800.00
	July 1		4,000.00	23,700.00	1 mo.	23,700.00
	Aug. 1	200.00		23,500.00	1 mo.	23,500.00
	Sept. 1	300.00		23,200.00	4 mos.	92,800.00
	Total				12 mos.	258,800.00

This method produces the same results as the first method, and has two advantages. First, the final amount in the Balance column should agree with the balance of the account, and thus prove the accuracy of the various balances; and second, the figures in the Time Unchanged column should add to a full year, and thus prove the accuracy of the multipliers.

In this illustration, all investments and withdrawals were made on the first day of some month. If investments and withdrawals are made during the month, the partners may agree that all investments and withdrawals shall date as from the first of the month; or that all shall date as from the end of the month; or that entries during the first half of the month shall date from the first day of the month, and entries during the last half of the month shall date from the last day of the month. Or the actual number of days may be used, as in the following illustration:

	<u>Date</u>	<u>Debits</u>	<u>Credits</u>	<u>Balance</u>	<u>Time</u>	<u>Products</u>
X, Capital:	Jan. 1		5,000.00	5,000.00	66 days	330,000.00
	Mar. 8	600.00		4,400.00	150 "	660,000.00
	Aug. 5	320.00		4,080.00	33 "	134,640.00
	Sept. 7		1,500.00	5,580.00	72 "	401,760.00
	Nov. 18	200.00		5,380.00	44 "	236,720.00
	Total				365 "	1,763,120.00

Interest on capital.—When the profits are divided in the ratio of the capitals at the beginning of the period, the capitals at the end of the period, or the average capitals, the entire profit distribution is based on the capital investments. Since capital is only one factor in the production of profits, it may be desired to distribute only a portion of the profit in the capital ratio and the remainder in some other ratio. This may be accomplished by:

- Allowing interest on the capitals, thus dividing a portion of the profit in the capital ratio; and
- Dividing the remainder of the profit in some other ratio.

If interest is to be allowed on capitals, the partnership agreement should contain definite provisions concerning the basis of the computation of the interest. Using the Capital accounts of *A* and *B* on page 5 and assuming that profits, after allowing 6% interest on capitals, are to be divided equally, the following methods of allowing interest may be illustrated:

- (1) Each partner is credited with interest for the entire period on the opening balance in his Capital account.

Summary of Division of Profit

	<u>A</u>	<u>B</u>	<u>Together</u>
Interest on opening capital balances:			
<i>A</i> —6% of \$10,000.00.....	\$ 600.00		
<i>B</i> —6% of \$20,000.00.....		\$1,200.00	
Total interest.....			\$ 1,800.00
Remainder equally.....	4,842.00	4,842.00	9,684.00
Total.....	<u>\$5,442.00</u>	<u>\$6,042.00</u>	<u>\$11,484.00</u>

- (2) Each partner is credited with interest for the entire period on the closing balance in his Capital account.

Summary of Division of Profit

	<u>A</u>	<u>B</u>	<u>Together</u>
Interest on closing capital balances:			
<i>A</i> —6% of \$11,200.00.....	\$ 672.00		
<i>B</i> —6% of \$23,200.00.....		\$1,392.00	
Total interest.....			\$ 2,064.00
Remainder equally.....	4,710.00	4,710.00	9,420.00
Total.....	<u>\$5,382.00</u>	<u>\$6,102.00</u>	<u>\$11,484.00</u>

- (3) Each partner is credited with interest for the entire period on his average capital balance. This basis

is obviously more equitable than either the opening or the closing balance. The computation of the average capital balances is shown on page 7.

Summary of Division of Profit

	<u>A</u>	<u>B</u>	<u>Together</u>
Interest on average capital balances:			
A—6 % of \$10,333.33.....	\$ 620.00		
B—6 % of \$21,566.67.....		\$1,294.00	
Total interest.....			\$ 1,914.00
Remainder equally.....	4,785.00	4,785 00	9,570 00
Total.....	<u>\$5,405.00</u>	<u>\$6,079 00</u>	<u>\$11,484.00</u>

(4) Interest is computed on each credit and each debit in the Capital accounts from the date thereof to the end of the period. This method produces the same results as those obtained by method 3, as shown by the following computation of the net interest credits.

A: Investments— \$10,000 00 for 12 months.....	\$ 600.00		
2,000.00 " 4 "	40.00		\$ 640.00
Withdrawals— 100.00 " 11 "	\$ 5 50		
500.00 " 5 "	12 50		
200.00 " 2 "	2.00		20 00
Net credit for interest.....			<u>\$ 620.00</u>
B: Investments— \$20,000.00 " 12 "	\$1,200.00		
4,000 00 " 6 "	120.00		\$1,320.00
Withdrawals— 300 00 " 10 "	\$ 15.00		
200.00 " 5 "	5.00		
300.00 " 4 "	6.00		26.00
Net credit for interest.....			<u>\$1,294.00</u>

It is obvious that, if interest is computed by either of the last three methods illustrated, the partners' interest credits are affected by debits in their Capital accounts. Therefore, if either of these methods is used, there should be a definite agreement with respect to withdrawals to be charged to the Capital accounts.

Object of interest on capital.—It should be noted that interest on capitals is really a division of a portion of the profits in the capital ratio, and the object of allowing interest on capital is to make a partial division of the profits in the capital ratio. Therefore it should be evident that there is

no object in allowing interest on capitals if the remaining profits are also to be divided in the capital ratio.

Interest on partners' accounts.—Partners may have Capital, Drawing, and Loan accounts. Two questions arise in connection with interest on these accounts:

- (1) Is interest to be charged or credited on these accounts, in the absence of an express agreement?
- (2) Where should interest on these accounts appear in the profit and loss statement?

As to the first question, a partner cannot claim interest on his capital unless there has been an agreement to that effect, for the law assumes that the investment was made for the purpose of earning profits and not interest. Nor can the partnership charge interest on a Drawing account when there has been no agreement to allow such a charge. And this rule holds even though the partner has drawn more than the agreed amount. But the rule is different in regard to loans. If a partner has contributed the agreed amount to the firm capital and made a loan in addition, the law considers him to be an outside creditor so far as the loan is concerned, and presumes that he made the loan with the expectation of receiving interest thereon.

As to the second question, interest on capital should be shown in the profit and loss statement as a division of profits. If interest is charged on drawings without being credited on capitals, the charge to the partners should be reflected as financial income in the profit and loss statement; if interest is credited on capitals and charged on drawings, the net amount should be shown as a division of profits. Interest on partners' loans should be shown as a financial expense.

Salaries to partners.—The relative value of the partners' services may be recognized by allowing salaries to the partners. The salaries may be paid monthly or at other intervals during the year; they may be credited at intervals to the partners' Drawing accounts as an offset against drawings taken from time to time; or they may be paid or credited in total at the end of the period. If the salaries are paid or credited at intervals throughout the period, they should be charged to the Partners' Salaries accounts; if paid or

credited in total at the end of the period, they may be charged to Partners' Salaries or direct to Profit and Loss.

One illustration should suffice. The Profit and Loss account of the firm of X and Y contains a credit balance of \$10,000.00, before closing the following salary accounts, which represent salaries paid to the partners during the year:

X, Salary.....	\$1,200.00
Y, Salary.....	3,000.00

The net profit, after the deduction of partners' salaries, is to be divided equally. The closing entries should be:

Profit and Loss.....	4,200.00	
X, Salary.....		1,200.00
Y, Salary.....		3,000.00
To close the salary accounts.		
Profit and Loss.....	5,800.00	
X, Capital....		2,900.00
Y, Capital....		2,900.00
To divide the remaining profits equally.		

Salaries and drawings.—The partnership agreement should definitely state whether the amounts which partners are allowed to draw during the period are to be considered as salaries or drawings. This agreement is important because it affects the distribution of the profits, for salaries are chargeable to the Profit and Loss account whereas drawings are chargeable to the respective Capital accounts.

Referring to the preceding illustration, if the amounts drawn by X and Y during the year were salaries, chargeable to Profit and Loss, their respective shares in the total profit of \$10,000.00 would be as follows:

	<u>X</u>	<u>Y</u>	<u>Together</u>
Amounts taken during the year as salaries	\$1,200.00	\$3,000.00	\$ 4,200.00
Profits divided equally:			
Total profit before salaries..	\$10,000.00		
Less salaries.....	4,200.00		
Remainder—net profit.....	\$ 5,800.00		
Divided equally.....	<u>2,900.00</u>	<u>2,900.00</u>	<u>5,800.00</u>
Total shares.....	<u>\$4,100.00</u>	<u>\$5,900.00</u>	<u>\$10,000.00</u>

But if the amounts drawn by X and Y during the year were drawings, to be closed to the respective Capital accounts, their shares in the total profit of \$10,000.00 would be:

	<u>X</u>	<u>Y</u>	<u>Together</u>
Equal division of total profit.....	\$5,000.00	\$5,000.00	\$10,000.00

The point may perhaps be made clearer if we compare the amounts which each partner is entitled to receive at the end of the year by the two methods.

	<u>X</u>	<u>Y</u>
If the amounts taken were drawings, the partners are entitled to receive at the end of the year:		
One half of total profits.....	\$5,000.00	\$5,000.00
Less amounts already drawn against their shares of profit.....	1,200.00	3,000.00
Remainder.....	<u>\$3,800.00</u>	<u>\$2,000.00</u>
If the amounts drawn were salaries, each partner is entitled to receive one half of the balance in the Profit and Loss account after closing the Salary accounts to that account, or.....	\$2,900.00	\$2,900.00

Obviously, X will prefer to have the amounts drawn during the year regarded as drawings, while Y will prefer to have them regarded as salaries. With such conflicting interests, it is evident that a dispute might easily arise in the absence of a specific agreement.

Partners' interest and salaries in the profit and loss statement.—There is some difference of opinion among accountants as to whether interest on capital and salaries to partners should be shown in the profit and loss statement as expenses or as divisions of profit.

To illustrate, by means of condensed statements, should interest and salaries be shown as expenses (as in the first statement) or as divisions of profits (as in the second statement)?

As expenses:

A AND B	
Profit and Loss Statement	
For the Year Ended December 31, 1933	
Sales.....	\$60,000.00
Less Cost of Goods Sold.....	40,000.00
Gross Profit on Sales.....	<u>\$20,000.00</u>
Deduct: Operating Expenses.....	\$8,000.00
Partners' Salaries.....	6,000.00
	<u>14,000.00</u>
Net Profit from Operations.....	\$ 6,000.00
Deduct Interest on Partners' Capitals.....	1,200.00
Net Profit for the Year.....	<u>\$ 4,800.00</u>
Distributed as Follows:	
A: $\frac{1}{2}$	\$2,400.00
B: $\frac{1}{2}$	2,400.00
Total.....	<u>\$4,800.00</u>

As divisions of profits:

A AND B			
Profit and Loss Statement			
For the Year Ended December 31, 1933			
Sales.			\$60,000.00
Less Cost of Goods Sold.			<u>40,000.00</u>
Gross Profit on Sales			\$20,000.00
Deduct Operating Expenses.			<u>8,000.00</u>
Net Profit for the Year.			<u>\$12,000.00</u>
Distributed as Follows:			
	<u>A</u>	<u>B</u>	<u>Together</u>
Salaries.	\$4,000.00	\$2,000.00	\$ 6,000.00
Interest on Capitals.	400 00	800.00	1,200.00
Balance Equally.	<u>2,400 00</u>	<u>2,400.00</u>	<u>4,800.00</u>
Total.	<u>\$6,800.00</u>	<u>\$5,200 00</u>	<u>\$12,000.00</u>

From a purely theoretical standpoint, it seems that partners' salaries and interest on partners' capitals are both divisions of profits. Partners are supposed to contribute capital and services for the purpose of producing partnership profits; and interest and salaries are merely devices for distributing profits in proportion to the amount of the capital and the value of the services contributed.

But in practice it is not unusual to show the partners' salaries as an expense, and the interest on capital as a division of profits.

Interest and/or salaries in excess of profits.—If the partnership agreement provides for interest on capitals without any stipulation as to what shall be done if the profits are less than the interest or if the operations result in a loss, the interest must be charged to Profit and Loss and credited to the partners' Capitals in accordance with the agreement, and the resulting debit balance in the Profit and Loss account must be charged to the Capital accounts.

The same rule holds with respect to partners' salaries; the agreed salaries must be charged to Profit and Loss and credited to the partners or paid to them, regardless of the amount of the profit or the loss. The following illustrations dealing with interest on partners' capitals should therefore be understood to apply equally to partners' salaries.

A and B have capitals of \$10,000.00 and \$20,000.00, respectively. Their partnership agreement provides that

“interest shall be allowed on capitals at 6% per annum, and remaining profits shall be divided equally.”

If the profits are \$8,000.00, they should be divided as follows:

	<u>A</u>	<u>B</u>	<u>Together</u>
Credits for interest.....	\$ 600.00	\$1,200.00	\$1,800.00
Balance divided equally....	<u>3,100.00</u>	<u>3,100.00</u>	<u>6,200.00</u>
Total.....	<u>\$3,700.00</u>	<u>\$4,300.00</u>	<u>\$8,000.00</u>

If the profits are only \$1,000.00, which is less than the interest credits, the division should be made as follows:

	<u>A</u>	<u>B</u>	<u>Together</u>
Credits for interest.	\$600.00	\$1,200.00	\$1,800.00
Resulting debit balance of Profit and Loss account—divided equally:			
Net profit.....	\$1,000 00		
Less debits for interest.....	1,800 00		
Debit balance of P. & L. . . .	<u>\$ 800 00</u>	400.00	400.00
Net credits to partners	<u>\$200 00</u>	<u>\$ 800.00</u>	<u>\$1,000.00</u>

If there is a loss of \$1,000.00, the division should be:

	<u>A</u>	<u>B</u>	<u>Together</u>
Credits for interest.....	\$ 600.00	\$1,200.00	\$1,800.00
Resulting debit balance of Profit and Loss account—divided equally:			
Net loss.....	\$1,000.00		
Add debits for interest....	<u>1,800.00</u>		
Total.....	<u>\$2,800.00</u>	1,400.00	2,800.00
Net division of loss.....	<u>\$ 800.00</u>	<u>\$ 200.00</u>	<u>\$1,000 00</u>

Compliance with the partnership agreement may result in giving one partner a net credit, although the business operations resulted in a loss. For instance, if the loss was \$400.00, the division should be made as follows:

	<u>A</u>	<u>B</u>	<u>Together</u>
Credits for interest.....	\$ 600.00	\$1,200.00	\$1,800.00
Resulting debit balance of Profit and Loss account—divided equally:			
Net loss.....	\$ 400.00		
Debits for interest. . . .	<u>1,800.00</u>		
Total.....	<u>\$2,200.00</u>	1,100.00	2,200.00
Net division.....	<u>\$ 500.00 Dr.</u>	<u>\$ 100.00 Cr.</u>	<u>\$ 400.00 Dr.</u>

If the partners wish to avoid distributions of the kind just illustrated, they must make express stipulations covering the contingency of a loss, or of profits which are less than the

interest. Such an agreement might be worded as follows: "Interest at 6% per annum shall be allowed on capitals, provided the profits exceed such interest credits; and the remaining profits shall be divided equally. In the event that the profits are less than interest on the capitals at 6% per annum, such profits as are made shall be divided in the capital ratio. Any loss shall be divided equally."

Applying this agreement to the illustration with profits of only \$1,000.00, which was less than the interest, the division should be made in the capital ratio of one third and two thirds, or \$333.33 to *A* and \$666.67 to *B*. In the case of a \$1,000.00 loss, \$500.00 should be charged to each.

The important thing to note is that, if the partnership agreement provides for interest on capitals or for partners' salaries, the agreement is unqualified. The salaries or the interest must be allowed to the partners regardless of the amount of the profit or loss, and any resulting debit balance in the Profit and Loss account must be divided in the ratio stated as applying to the division of remaining profits.

Bonus to a partner.—When one partner manages the business, a special compensation may be allowed to him, in the form of a bonus based on the profits. Bonus agreements should state definitely whether the bonus is to be considered an expense or a distribution of profits. In other words, the agreement should specify whether the profits are to be considered net before or after the bonus is deducted.

To illustrate the difficulties which may arise if the agreement does not specifically cover this point, assume that *A* and *B* are partners; that *A* is to be allowed a bonus of 20% of the profits; and that remaining profits are to be divided equally. The Profit and Loss account shows a credit balance of \$5,000.00.

If the bonus is not to be considered an expense and the profits are assumed to be net before the bonus is deducted, the distribution will be:

	<u>A</u>	<u>B</u>	<u>Together</u>
Bonus to <i>A</i> : 20% of \$5,000.00.....	\$1,000.00		\$1,000.00
Balance equally.....	2,000.00	\$2,000.00	4,000.00
Total.....	<u>\$3,000.00</u>	<u>\$2,000.00</u>	<u>\$5,000.00</u>

On the other hand, if the bonus is to be considered an

expense, the net profits are not \$5,000.00, but \$5,000.00 minus the bonus. The computation of the bonus and the distribution of the profits would be made as follows:

Let net profits = 100%
 And bonus = 20%
 Then \$5,000.00 = 120% of net profits
 $\$5,000.00 \div 120\% = \$4,166.67$, the net profit

	<u>A</u>	<u>B</u>	<u>Together</u>
Bonus to A: 20% of \$4,166.67.....	\$ 833.33		\$ 833.33
Balance equally.....	2,083.33	2,083.34	4,166.67
Total.....	<u>\$2,916.66</u>	<u>\$2,083.34</u>	<u>\$5,000.00</u>

Statement of partners' capitals.—The increases and decreases in partners' net investments during the period are shown by a statement of partners' capitals. To illustrate the form, assume the following facts for the year 1934:

Partner A:

Capital account:

Credit balance at beginning of year.....	\$20,000 00
Additional investments during the year.....	3,000.00
Debits for drawings in excess of agreed monthly drawings of \$200.00.....	\$1,500.00
Drawing account: debits for monthly drawings.....	2,400.00

Partner B:

Capital account:

Credit balance at beginning of year.....	15,000.00
Additional investments during the year.....	2,500.00
Debits for drawings in excess of agreed monthly drawings of \$200.00.....	1,000.00
Drawing account: debits for agreed monthly drawings.....	2,400.00

Profit and Loss account: credit balance—to be divided equally.....

8,000.00

The changes in the partners' capitals during the year are shown by the following statement.

A AND B
Statement of Partners' Capitals
Year Ended December 31, 1934

	<u>A</u>	<u>B</u>	<u>Together</u>
Balances, January 1, 1934.....	\$20,000.00	\$15,000.00	\$35,000.00
Add: Additional Investments.....	3,000.00	2,500.00	5,500.00
Net Profits.....	4,000.00	4,000.00	8,000.00
Total.....	<u>\$27,000.00</u>	<u>\$21,500.00</u>	<u>\$48,500.00</u>
Deduct Withdrawals.....	3,900.00	3,400.00	7,300.00
Balances, December 31, 1934.....	<u>\$23,100.00</u>	<u>\$18,100.00</u>	<u>\$41,200.00</u>

Adjustment of profits of prior periods.—If it is necessary to adjust the profits of prior periods, the adjustment should be made in the partners' Capital accounts and not in the Profit and Loss account. There are two reasons for this. In the first place, the Profit and Loss account is intended to show only the profits for the current period. In the second place, if the profit and loss ratio has changed, the adjustment should affect the partners' capitals in the ratio which prevailed during the period in which the error was made; if the adjustment were put through the Profit and Loss account, it would affect the capitals in the ratio of the period in which the error was discovered.

CHAPTER 32

PARTNERSHIPS (Continued)

Dissolution

Dissolution of a partnership.—A partnership is based on a contract, and when the contract is terminated the partnership is dissolved. It is important to recognize the fact that the dissolution of a partnership does not necessarily mean the discontinuance of the business; it means merely that the old partnership contract, formerly existing, is no longer in force. After the contract is terminated and the partnership thus dissolved, the business may go out of existence; on the other hand, a new partnership contract may be formed and the business continued.

Causes of dissolution.—The causes of partnership dissolution are classified as follows:

(A) Act of the parties.

- (1) Termination of the time agreed upon in the contract.

If, at the time of making the partnership contract, the parties agree upon the length of time the contract shall remain in force, the termination of the agreed time dissolves the partnership. The partners may continue the partnership relation, but it is thereafter a "partnership at will" and any partner may withdraw at any time.

- (2) Accomplishment of the purpose for which the partnership was formed.

If the partnership contract states that the partnership was formed for a definite purpose, as for the purchase and sale of a certain invoice of merchandise, or for the construction of a building, the accomplishment of the

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stated purpose discharges the contract and dissolves the partnership.

(3) Mutual agreement.

Since a partnership is based on a contract, the parties to the contract may, by mutual consent at any time, agree to terminate the contract.

(4) Withdrawal of a partner.

It has already been noted that a partner has the *right* to withdraw if (1) the agreed time has elapsed, (2) the stated purpose has been accomplished, or (3) a mutual agreement has been reached. A partner has the *power* to withdraw at any time even though he may have no right to do so. A partner's withdrawal without the right to withdraw is a violation of his contract, and renders him liable for any damages that may result from such violation. But his withdrawal nevertheless dissolves the partnership.

(B) Operation of law.

(1) Death of a partner.

The death of a partner automatically dissolves the partnership. The articles of partnership may provide that the deceased partner's estate or heirs may succeed him in the partnership. But such a provision results in the creation of a new partnership; it does not prevent the dissolution of the old one.

(2) Bankruptcy.

The bankruptcy of the firm or of a partner dissolves the partnership.

(3) War.

If the partners are citizens or subjects of different countries, the partnership is dissolved by war between these countries, or at least suspended during the continuance of the war.

(4) Illegality of object.

A partnership cannot be formed for an illegal purpose, and a legally organized partnership is dissolved by the subsequent enactment

of legislation making the business of the firm illegal.

(C) Judicial decree.

A partner may appeal to a court for a decree dissolving the partnership for any of the following reasons:

- (1) Insanity or other incapacity of one of the partners.
- (2) Dissension among the partners.
- (3) Misconduct of a partner, tending to interfere with the success of the business.
- (4) Inability to make profits.
- (5) Fraud in the inducement that caused him to become a partner.

Purpose of dissolution.—It should be borne in mind that the dissolution of a partnership means merely the termination of the contract theretofore existing between the partners. The partnership may be dissolved for the purpose of discontinuing the business, or for the purpose of changing the personnel of the partnership or the form of organization.

With these points in mind, it seems desirable to classify the purposes of partnership dissolution and thus furnish an outline to be followed in the discussion of the accounting principles involved.

The reasons for the dissolution of a partnership are:

- | | |
|---------------------------------------|----------------------------|
| (1) Admission of a partner. | Discussed in this chapter. |
| (2) Retirement of a partner. | } Discussed in Chapter 33. |
| (3) Sale of the business. | |
| (4) Change to corporate organization. | |
| (5) Liquidation. | |

Admission of a New Partner

Admission follows dissolution.—When a new partner is admitted, a new partnership is created. The creation of the new partnership automatically dissolves the old one, since the agreement which formerly bound the old partners is now superseded by a new agreement binding the new partners. Therefore new articles of partnership should be drawn up, because the old articles cannot be assumed to bind the new partner, who was not a party to the old contract.

Purchase of an interest distinguished from investment.—

A new partner may gain admission to the firm in either of two ways:

- (1) By purchasing all or a portion of the interest of an old partner.
- (2) By making a contribution to the capital of the partnership.

Purchase of an interest.—No partner has a right to sell all or a portion of his interest in the capital of the firm without the consent of the other partners. The right to choose one's associates in a partnership is a fundamental right; if a partner attempts to sell his interest without the consent of the other partners, he dissolves the partnership, and the purchaser does not become a partner. (This is the rule under the common law, which is somewhat modified by the Uniform Partnership Act.) The purchaser obtains only the right to demand a settlement of the affairs of the firm and a payment of whatever interest may remain to him after the assets have been realized and the liabilities paid. Moreover, the partner who sells without consent is liable to his former partners for whatever loss they may sustain as a result of his action.

If the sale is made with mutual consent, a new partnership is formed. As the payment is made by the purchasing partner to the selling partner, the cash or other assets given in payment will not appear on the firm's books. The only entry required is one transferring a capital credit from the account of the old partner to the account of the new one.

To illustrate, assume that *A*, *B*, and *C* have capitals of \$10,000.00, \$15,000.00, and \$20,000.00, respectively. By mutual consent, *C* sells one half of his capital interest to *D* for the sum of \$12,000.00. The only entry required on the partnership books is:

C, Capital.....	10,000.00	
D, Capital.....		10,000.00
To record the sale of one half of C's capital to D.		

Since the sale of all or a portion of one partner's interest dissolves the old partnership, new articles should be drawn

up for the new partnership. It is particularly important that the new profit and loss sharing ratio be definitely agreed upon, because the dissolution of the old partnership cancels the old profit and loss sharing agreement.

Investment in a partnership.—A new partner may gain admission to the firm by making a contribution to the partnership capital. The assets contributed are in this instance placed on the firm's books. It is essential that the assets thus contributed be properly valued, because any subsequent loss or gain on the sale of these assets becomes a partnership loss or gain and not a loss or gain of the contributing partner.

To illustrate, assume that *A* and *B* are in partnership, with capitals of \$10,000.00 each. They occupy a store building owned by *C*, and it is decided to take *C* into partnership. *C* is to contribute his store property as his investment, and profits are to be shared equally. The store property is really worth \$13,000.00, but *C* unwisely allows it to be placed on the books at \$10,000.00 so that his capital will be equal to that of each of the other two partners.

The fact that profits are to be shared equally does not mean that the capitals must be equal; *C* could have been credited with \$13,000.00, the true value of the property, and still have taken only one third of the profits. And he should have been credited with \$13,000.00, for if the property is placed on the books at \$10,000.00 and is subsequently sold for \$13,000.00, the three partners will share equally in the profit of \$3,000.00.

Outline of cases—Investments in a partnership.—The five following cases illustrate the following conditions with respect to investments in partnerships:

- (1) No goodwill allowed to old or new partners.
- (2) Goodwill allowed to old partners.
- (3) Goodwill allowed to new partner.
- (4) Bonus allowed to old partners.
- (5) Bonus allowed to new partner.

Case 1: No GOODWILL.—If no goodwill is to be placed on the books, the only entries necessary to record the admission of a partner are:

- (1) Entries to adjust the valuation of any of the assets of the old partnership in accordance with the agreement.
- (2) Entries to record the investment of the new partner.

To illustrate, assume that *A* and *B*, sharing profits equally, have capitals of \$10,000.00 and \$15,000.00, respectively. Their land is to be written up from \$1,000.00 to \$1,500.00; the reserve for bad debts is to be increased \$200.00; and *C* is to enter the firm with an investment of \$12,000.00. The entries are:

Land.....	500.00	
A, Capital.....		250.00
B, Capital.....		250.00
To write up the land from \$1,000.00 to \$1,500.00 in accordance with the agreement with <i>C</i> , prior to his admission.		
A, Capital.....	100.00	
B, Capital.....	100.00	
Reserve for Bad Debts.....		200.00
To add \$200.00 to the reserve for bad debts.		
Cash.....	12,000.00	
C, Capital.....		12,000.00
To record <i>C</i> 's investment.		

The accounts of the partners now stand as follows:

A.....	\$10,150.00
B.....	15,150.00
C.....	12,000.00

There is no statement in this illustration regarding the profit sharing ratio which is to prevail in the new firm, for this ratio has no bearing on the entries to be made at the time of the admission of *C*.

Case 2: GOODWILL ALLOWED TO OLD PARTNERS.—If goodwill is to be allowed to the old partners, it should be placed on the books prior to the admission of the new partner, and the credit therefor should be divided between the old partners in their profit and loss ratio.

To illustrate, *A* and *B*, sharing profits in the ratio of two thirds and one third, respectively, have capitals of \$15,000.00 and \$20,000.00. *C* is to invest \$10,000.00 in the business, but prior to his admission a goodwill of \$3,000.00 is to be

placed on the books. The necessary entries are:

Goodwill.....	3,000.00	
<i>A</i> , Capital.....		2,000.00
<i>B</i> , Capital.....		1,000.00
To record the goodwill of the firm of <i>A</i> and <i>B</i> , in accordance with the agreement made prior to the admission of <i>C</i> .		
Cash.....	10,000.00	
<i>C</i> , Capital.....		10,000.00
To record <i>C</i> 's capital investment.		

The capital accounts of the three partners now stand as follows:

<i>A</i>	\$17,000.00
<i>B</i>	21,000.00
<i>C</i>	10,000.00

Case 3: GOODWILL ALLOWED TO NEW PARTNER.—Sometimes the new partner is allowed a credit for goodwill because he has been conducting a successful business and is expected to bring patronage with him.

To illustrate, *A* and *B*, with capitals of \$10,000.00 and \$20,000.00, admit *C* to partnership. *C* invests \$12,000.00 of merchandise and is allowed \$3,000.00 credit for goodwill. The journal entry is:

Merchandise.....	12,000.00	
Goodwill.....	3,000.00	
<i>C</i> , Capital.....		15,000.00
To record the admission of <i>C</i> as a partner.		

The capital accounts of the three partners now stand as follows:

<i>A</i>	\$10,000.00
<i>B</i>	20,000.00
<i>C</i>	15,000.00

Case 4: BONUS ALLOWED TO OLD PARTNERS.—Instead of placing a Goodwill account on the books, the old partners may demand a bonus. In that instance, a portion of the capital contributed by the new partner is credited to the accounts of the old partners. This credit is divided between the old partners in their profit and loss ratio, unless otherwise agreed.

To illustrate, *A* and *B*, sharing profits equally and having capitals of \$15,000.00 and \$20,000.00, respectively, agree to admit *C*, on condition that he contribute \$17,000.00, of which \$2,000.00 shall be credited to their accounts. The journal entry is:

Cash.....	17,000.00	
<i>A</i> , Capital.....		1,000.00
<i>B</i> , Capital.....		1,000.00
<i>C</i> , Capital.....		15,000.00
To record the admission of <i>C</i> and his contribution of \$17,000.00, of which \$2,000.00 is credited as a bonus to the old partners in their profit and loss ratio.		

The accounts of the partners now stand as follows:

<i>A</i>	\$16,000.00
<i>B</i>	21,000.00
<i>C</i>	15,000.00

Case 5: BONUS ALLOWED TO NEW PARTNER.—It is sometimes necessary to allow a bonus to the new partner. Under such circumstances, the new partner is credited with his contribution, and the required bonus is transferred from the accounts of the old partners to the account of the new partner. Unless some other agreement is made, the bonus is charged to the old partners in their profit and loss ratio.

To illustrate, *A* and *B*, having capitals of \$15,000.00 and \$10,000.00 and sharing profits equally, admit *C* to partnership. *C* is to contribute \$13,000.00 and receive a total capital credit of \$15,000.00. The credit of \$2,000.00 in addition to *C*'s cash contribution is to be obtained by transfer from the accounts of the old partners. The entries are:

Cash.....	13,000.00	
<i>C</i> , Capital.....		13,000.00
To record the cash contribution made by <i>C</i> .		
<i>A</i> , Capital.....	1,000.00	
<i>B</i> , Capital.....	1,000.00	
<i>C</i> , Capital.....		2,000.00
To record the bonus transferred from <i>A</i> and <i>B</i> to <i>C</i> .		

Implied goodwill or bonus.—Examinations for the C. P. A. certificate have often contained problems of the five types

just illustrated, dealing with the admission of a partner. In some of these C. P. A. problems, there is no express statement as to whether the old or new partners are to be allowed a goodwill or a bonus, but sufficient information is given to enable the candidate to determine by analysis whether a goodwill or a bonus is implied. Problems of this nature may be divided into two groups, depending on the information given.

First type of problems.—In problems of this type the following information is given:

Capitals of old partners.

Incoming partner's contribution.

Total agreed capital of the new firm.

Fractional interest in total capital allowed the incoming partner.

Five illustrations are given, covering the five typical cases.

Case 1: NO GOODWILL OR BONUS.—*A* and *B* have capitals of \$10,000.00 and \$20,000.00, respectively. *C* is to contribute \$10,000.00. The total capital of the new firm is to be \$40,000.00, and *C* is to have a one-fourth interest therein.

The three capitals, as stated, add to \$40,000.00, the agreed total capital; therefore there is no goodwill. *C*'s capital is equal to his contribution; therefore no bonuses are to be allowed.

Cash.....	10,000.00	
<i>C</i> , Capital.....		10,000.00
To record <i>C</i> 's contribution.		

Case 2: GOODWILL TO OLD PARTNERS.—*A* and *B* have capitals of \$10,000.00 and \$20,000.00, respectively. They share profits equally. *C* is to contribute \$11,000.00 for a one-fourth interest in the agreed total capital of \$44,000.00.

The capitals of *A* and *B*, plus the contribution of *C*, amount to \$41,000.00. But since the total capital is to be \$44,000.00, it is necessary to put a Goodwill account of \$3,000.00 on the books. As *C*'s credit of \$11,000.00 is equal to the amount of cash paid in, he is to receive no credit for goodwill; hence the goodwill is to be credited to the old partners.

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Goodwill.....	3,000.00	
A, Capital.....		1,500.00
B, Capital.....		1,500.00
To place the goodwill on the books.		
Cash.....	11,000.00	
C, Capital.....		11,000.00
To record C's contribution.		

Case 3: GOODWILL TO NEW PARTNER.—*A* and *B* have capitals of \$10,000.00 and \$20,000.00, respectively. *C* is admitted to partnership, paying in \$8,000.00. The total capital is to be \$40,000.00, and *C* is to have one fourth thereof.

The capitals of *A* and *B* plus *C*'s cash contribution amount to \$38,000.00. But since the total capital is to be \$40,000.00, a Goodwill account of \$2,000.00 must be put on the books. This goodwill must be credited to *C* to make his total capital \$10,000.00, or one fourth of \$40,000.00.

Cash.....	8,000.00	
Goodwill.....	2,000.00	
C, Capital.....		10,000.00
To record C's admission to the partnership.		

Case 4: BONUS TO OLD PARTNERS.—*A* and *B* have capitals of \$10,000.00 and \$20,000.00, respectively. They share profits equally. *C* is to contribute \$14,000.00 for a one-fourth interest in the total capital of \$44,000.00.

The capitals of *A* and *B* plus *C*'s contribution amount to \$44,000.00, the agreed total capital. Hence it is unnecessary to put a Goodwill account on the books. But *C* pays in \$14,000.00 and receives credit for only one fourth of \$44,000.00, or \$11,000.00. Hence \$3,000.00 of his contribution must be credited to the old partners as a bonus.

Cash.....	14,000.00	
A, Capital.....		1,500.00
B, Capital.....		1,500.00
C, Capital.....		11,000.00
To record C's admission to the partnership.		

Case 5: BONUS TO NEW PARTNER.—*A* and *B* have capitals of \$10,000.00 and \$20,000.00, respectively. They share profits equally. *C* is to pay in \$8,000.00 for a one-fourth interest in a total capital of \$38,000.00.

The capitals of *A* and *B* plus *C*'s contribution amount

to \$38,000.00. Hence there is to be no Goodwill account. But *C* is to pay in \$8,000.00 and receive credit for one fourth of \$38,000.00, or \$9,500.00. Hence a bonus of \$1,500.00 must be transferred to him.

Cash.....	8,000.00	
<i>C</i> , Capital.....		8,000.00
To record <i>C</i> 's cash contribution.		
<i>A</i> , Capital.....	750.00	
<i>B</i> , Capital.....	750.00	
<i>C</i> , Capital.....		1,500.00
To record the transfer of a bonus from <i>A</i> and <i>B</i> to <i>C</i> .		

Second type of problems.—In problems of this type the following information is given:

Capitals of old partners.

Incoming partner's contribution.

Capital credit allowed new partner, and fraction of total represented thereby.

This type of problems does not differ essentially from problems of the first type. The only difference is that the total agreed capital is not stated; but the information concerning the capital credit allowed the new partner and the fraction of the total represented thereby, is sufficient to make possible the computation of the total capital.

Case 1: NO GOODWILL OR BONUS.—*A*'s capital is \$10,000.00; *B*'s capital, \$20,000.00; *C* pays in \$10,000.00 for a one-fourth interest in the capital and is credited therewith.

The total capital is to be four times \$10,000.00, or \$40,000.00. The capitals add to \$40,000.00, and *C*'s contribution is one fourth thereof; hence there is no goodwill or bonus.

Case 2: GOODWILL TO OLD PARTNERS.—*A*'s capital is \$10,000.00; *B*'s capital, \$20,000.00. Profits are shared equally. *C* contributes and is credited with \$11,000.00, representing a one-fourth interest in the capital.

As *C*'s capital of \$11,000.00 is one fourth of the total, the entire capital must be \$44,000.00. The capitals of *A* and *B* plus *C*'s contribution amount to only \$41,000.00. Hence there must be a goodwill of \$3,000.00, to be allowed to the old partners.

Case 3: GOODWILL TO NEW PARTNER.—*A*'s capital is \$10,000.00; *B*'s capital, \$20,000.00. *C* pays in \$8,000.00 and

is to have a capital credit of \$10,000.00, or one fourth of the total capital.

The total capital is to be four times \$10,000.00, or \$40,000.00. The present capitals and *C*'s contribution add to \$38,000.00. Hence there must be a goodwill of \$2,000.00, which must be allowed to *C* to make up the difference between his \$8,000.00 contribution and the capital credit of \$10,000.00 allowed him.

Case 4: BONUS TO OLD PARTNERS.—*A*'s capital is \$10,000.00; *B*'s capital, \$20,000.00. Profits are shared equally. *C* pays in \$14,000.00 and is credited with \$11,000.00, as one fourth of the total capital.

The total capital is to be four times \$11,000.00, or \$44,000.00. The present capitals and *C*'s contribution add to \$44,000.00; hence there is no goodwill. As *C* pays in \$14,000.00 and is credited with only \$11,000.00, the other partners must be credited with \$3,000.00 as a bonus.

Case 5: BONUS TO NEW PARTNER.—*A*'s capital is \$10,000.00; *B*'s capital, \$20,000.00. Profits are shared equally. *C* contributes \$8,000.00 and is to be credited with \$9,500.00, as a one-fourth interest in the capital.

The total capital is four times \$9,500.00, or \$38,000.00. The present capitals and *C*'s contribution add to this sum; hence there is no goodwill. But *C* pays in \$8,000.00 and is credited with \$9,500.00. The additional \$1,500.00 must be transferred from the old partners' capitals to the new partner's capital as a bonus.

Vague problems.—Some problems dealing with the admission of a partner do not contain enough information to permit of a positive solution. To make journal entries for the admission of a partner, the following information must be stated by the problem or be obtainable by analysis:

- Original capitals of old partners.
- Contribution of the new partner.
- Total capital of the new firm.
- Capital credit of the new partner.

The following is cited as an illustration of a vague problem, impossible of a positive solution:

A and *B*, with capitals of \$10,000.00 and \$20,000.00, respectively, and sharing profits equally, admit *C* to a one-fourth interest in the capital by the payment of \$12,000.00.

This problem does not state either the total capital of the new firm or the credit to be given to the new partner. It may therefore be solved in either of two ways.

First, it may be assumed that *C* is to be credited with \$12,000.00. On this assumption, the total capital will be four times \$12,000.00, or \$48,000.00. Since the capitals of *A* and *B*, plus *C*'s contribution, amount to \$42,000.00, it becomes necessary to put a \$6,000.00 Goodwill account on the books. The entries, on this assumption, are:

Goodwill.....	6,000.00	.
<i>A</i> , Capital.....		3,000.00
<i>B</i> , Capital.....		3,000.00
Cash.....	12,000.00	
<i>C</i> , Capital.....		12,000.00

The capitals are:

<i>A</i>	\$13,000.00
<i>B</i>	23,000.00
<i>C</i>	12,000.00

Second, it may be assumed that the capital is to be the sum of *A*'s and *B*'s capitals plus *C*'s contribution, or \$42,000.00. *C* is to have one fourth of this capital, or \$10,500.00. But since *C* pays in \$12,000.00, there is a bonus of \$1,500.00 to be divided between *A* and *B*. The entries, on this assumption, are:

Cash.....	12,000.00	
<i>A</i> , Capital.....		750.00
<i>B</i> , Capital.....		750.00
<i>C</i> , Capital.....		10,500.00

The capitals are:

<i>A</i>	\$10,750.00
<i>B</i>	20,750.00
<i>C</i>	10,500.00

CHAPTER 33

PARTNERSHIPS (Continued)

Retirement of a Partner

Adjustment of asset values.—When a partner retires, he has a right to be paid the amount of his equity in the business. But the question arises whether his equity is fairly measured by the balance of his Capital account. Three classes of adjustments in the asset values may be necessary to produce a balance in the retiring partner's Capital account which is a fair amount for him to demand and receive.

In the first place, improper provision for bad debts, depreciation, and other shrinkages in asset values may have been made during the years of operation. The provisions may have been insufficient or excessive, and this fact becomes significant when one partner is to withdraw. If the provisions have been insufficient, a hardship will be worked on the remaining partners unless an adjustment is made; if the provisions have been excessive, an adjustment should be made to avoid working a hardship on the retiring partner.

In the second place, the rules which properly govern the valuation of assets in a going concern may not be the proper rules to apply in valuing the assets of a partnership which is about to dissolve. For instance, in figuring the profits of a going concern, it is a conservative practice to value the inventory at cost or market, whichever is lower; but when a partner is about to retire, he is virtually selling his interest in the inventory to the remaining partners, and justice would seem to require that he receive the benefit of any increase in the market value of the merchandise which took place before his retirement.

Fixed assets provide another illustration. From the standpoint of a going concern, fluctuations in the market value of fixed assets need not be recorded in the accounts. An increase in value is an unrealized profit, and a decrease

secret partner, he is liable to former creditors for debts incurred after his retirement if such creditors have no notice of his retirement and extend credit on the assumption that he is still a partner. Therefore it is advisable for a retiring partner to give notice, either orally or in writing, to all parties with whom the firm has had dealings.

Settlement with retiring partner.—The cash or other assets given to the withdrawing partner should be charged to his account. If he is paid in full, the account will, of course, be closed. In some instances, however, full payment is deferred, either because of the inadequacy of funds, or because an agreement cannot be reached regarding the value of certain assets, such as accounts receivable, and it is decided to postpone payment until the assets have been converted into cash and the losses ascertained.

When settlement is thus postponed, the Capital account of the retiring partner should be closed, because he is no longer a partner; and the balance of the Capital account should be transferred to a personal account or a Note Payable account, as the case may be. This account should be given a title which will clearly distinguish it from the trade accounts and notes payable.

If the settlement is postponed, pending the realization of doubtful assets, such as accounts receivable, the accounts with these assets should be kept entirely distinct from the accounts with similar assets obtained after the partner's retirement. Otherwise there may be difficulty in determining whether or not a loss should be charged in part to the former partner.

Death of a partner.—The death of a partner automatically dissolves the partnership, and it becomes the duty of the surviving partners to wind up the affairs of the partnership and to make a settlement with the deceased partner's estate.

If the articles of partnership contain no provisions with respect to the death of a partner, the surviving partners should realize that the partnership has been dissolved and that the estate of the deceased partner is entitled to receive the amount of his interest in the firm at the date of his death. Therefore, the surviving partners should immediately take an inventory and close the books, to determine the capital interest of the deceased partner, including his share of the

profits to the date of his death. As the decedent is no longer a partner, the balance of his Capital account should be transferred to a personal account, pending settlement with the estate.

The articles of partnership may, however, contain provisions intended to avoid the necessity of taking an inventory and closing the books at the date of death. If the determination of the actual profits to the date of death and the determination of current values of assets as of that date are not required for estate or inheritance tax purposes, the following procedures may be effective:

- (A) There may be an agreement that the estate or an heir of the decedent shall succeed him as a partner.

When such an agreement has been made, it is not necessary to close the books and to ascertain the profits to the date of death. It is necessary only to close the deceased partner's Drawing account, and to transfer his capital credit to a Capital account with the estate or the heir. At the next regular closing, the share of profits credited to the estate or the heir will include the profits earned to the date of death, as well as those earned subsequently. The questions of goodwill and the realizable value of assets at the date of the partner's decease may be ignored, because the estate or heir merely steps into the decedent's place as a partner of a going business.

- (B) If the deceased partner's interest is to be paid to his estate, the articles may contain an agreement that the profits to the date of death shall be estimated in some manner, instead of being actually computed by taking an inventory and closing the books. The methods of making the estimate may be divided into two general classes, as follows:

- (1) The profits to the date of death may be estimated on the basis of an average of the profits of a number of years preceding the year of death. For instance, *A*, *B*, and *C*, sharing profits equally, agreed that, in the event of the death of a partner, the deceased partner's share of profits from the date of the last

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closing until the date of death should be estimated by averaging the profits of the past four years and multiplying this average by the fraction of the year between the date of the last closing and the date of death. A died on March 31, 1933, and his share of the profits earned since the preceding December 31 was estimated as follows:

<u>Year</u>	<u>Profits</u>
1929.....	\$18,500.00
1930.....	17,625.00
1931.....	18,346.00
1932.....	18,297.00
Total.....	<u>\$72,768.00</u>
Average.....	<u>\$18,192.00</u>
Fraction of year since last closing.....	<u>¼</u>
Estimated profits for three months.....	<u>\$ 4,548.00</u>
A's fractional interest.....	<u>⅓</u>
A's estimated share of profits.....	<u>\$ 1,516 00</u>

These estimated profits should be credited to A by a journal entry similar to the following:

A's Estimated Profits.....	1,516.00
A, Capital.....	1,516.00
To credit A with his share of the estimated profit for the three months ended March 31, 1933.	

The account called A's Estimated Profits should remain open until the closing of the books on December 31, 1933, when it should be closed to Profit and Loss as a division of the profits.

- (2) The articles may provide that settlement with the deceased partner's estate shall be postponed until the next regular closing, at which time his account shall be credited with a share of the profits.

Various methods may be agreed upon for computing the deceased partner's portion of the profit. Since the partnership retained his capital during the full period, he may receive a share of the profits for the full period.

Or his account may be credited with a share of the profits for the full period minus an allowance for the loss of his services. Or the credit may be for the proper fraction of the period's profits, plus interest on his capital and on his share of the profits from the date of death to the date of settlement.

When settlement is thus postponed, the balance of the deceased partner's Capital account should be transferred to a personal account or to an account with the estate.

The articles of partnership may also contain an agreement as to goodwill, and as to the recognition of the market value of other assets as of the date of the death of a partner.

Sale of a Partnership Business

Valued assets or lump sum.—When a business is sold, the seller and purchaser may agree upon the valuation of each asset, or they may agree on a lump-sum price for the business as a whole. The method of recording the sale will depend upon which of these methods is adopted.

Several illustrations will be given, assuming the sale of a business with the following balance sheet:

A, B, AND C	
Balance Sheet—April 30, 1933	
Assets	
Land.....	\$ 1,000.00
Buildings.....	\$6,000.00
Less Reserve for Depreciation.. . . .	800.00
	5,200.00
Merchandise.....	4,800.00
Accounts Receivable.....	\$4,560.00
Less Reserve for Bad Debts.... . . .	140.00
	4,420.00
Cash.....	280.00
	\$15,700.00
Liabilities	
Accounts Payable...	\$ 1,000.00
Notes Payable...	500.00
A, Capital...	6,100.00
B, Capital...	5,100.00
C, Capital...	3,000.00
	\$15,700.00

Profits and losses are shared equally.

Valued assets.—It is first assumed that the assets are sold to J. G. Burroughs at the following agreed values:

Land.....	\$1,500.00
Buildings	5,000 00
Merchandise.....	4,500.00
Accounts Receivable	4,000.00

The cash is not sold, and the liabilities are not assumed by the purchaser.

The procedure for recording the sale may be summarized as follows:

Adjust the asset values, closing out the various reserves, and taking up the net gain or loss to the partners' capitals in the profit and loss ratio. The gain or loss may be entered directly in the Capital accounts or carried through a Capital Adjustment account.

Close out the asset accounts, charging a Vendee account.

Record the collection from the vendee.

Record the payment of the liabilities.

Record the final distribution of assets among the partners.

The journal entries to record the sale, in accordance with the terms stated in the illustration, the payment of the liabilities, and the distribution to the partners, are as follows:

(1) Land.....	500.00	
Capital Adjustment Account.....		500.00
To write up the land to the agreed value of \$1,500.00.		
(2) Reserve for Depreciation—Buildings.....	800.00	
Capital Adjustment Account	200.00	
Buildings		1,000.00
To write down the buildings to the agreed value of \$5,000.00, closing the reserve and recording the loss of \$200.00.		
(3) Capital Adjustment Account.....	300.00	
Merchandise.....		300.00
To write down the merchandise from \$4,800.00 to the agreed value of \$4,500.00.		
(4) Reserve for Bad Debts.....	140.00	
Capital Adjustment Account.....	420.00	
Accounts Receivable.....		560.00
To write down the accounts receivable from \$4,560.00 to \$4,000.00, closing the reserve and taking up the loss of \$140.00.		

- | | | |
|--|-----------|-----------|
| (5) A, Capital..... | 140.00 | |
| B, Capital..... | 140.00 | |
| C, Capital..... | 140.00 | |
| Capital Adjustment Account..... | | 420.00 |
| To divide the loss on the sale in the profit and loss ratio. | | |
| (6) J. G. Burroughs, Vendee..... | 15,000.00 | |
| Land..... | | 1,500.00 |
| Buildings..... | | 5,000.00 |
| Merchandise..... | | 4,500.00 |
| Accounts Receivable.. | | 4,000.00 |
| To record the sale of the assets at the agreed values. | | |
| (7) Cash..... | 15,000.00 | |
| J. G. Burroughs, Vendee..... | | 15,000.00 |
| To record the collection from Burroughs..... | | |
| (8) Accounts Payable..... | 1,000.00 | |
| Notes Payable..... | 500.00 | |
| Cash..... | | 1,500.00 |
| To record the payment of the liabilities. | | |
| (9) A, Capital..... | 5,960.00 | |
| B, Capital..... | 4,960.00 | |
| C, Capital..... | 2,860.00 | |
| Cash..... | | 13,780.00 |
| To record the final distribution of cash. | | |

	<u>A</u>	<u>B</u>	<u>C</u>
Capitals.....	6,100.00	5,100.00	3,000.00
Less loss on sale..	140.00	140.00	140.00
Cash.....	<u>5,960.00</u>	<u>4,960.00</u>	<u>2,860.00</u>

Lump-sum sale: At a loss.—When the assets are sold for a lump sum, it is impossible to adjust the asset values. If the price is less than the book value of the assets transferred, the loss should be taken up in the entry for the sale.

To illustrate, assume that the assets of A, B, and C, exclusive of the cash, are sold for a lump sum of \$15,000.00, without placing values on the individual assets. The entries for the transfer of the assets will be:

- | | | |
|---|-----------|----------|
| (1) J. G. Burroughs, Vendee..... | 15,000.00 | |
| Reserve for Depreciation—Buildings.. | 800.00 | |
| Reserve for Bad Debts..... | 140.00 | |
| Capital Adjustment Account..... | 420.00 | |
| Land..... | | 1,000.00 |
| Buildings..... | | 6,000.00 |
| Merchandise..... | | 4,800.00 |
| Accounts Receivable..... | | 4,560.00 |
| To record the sale of the assets, exclusive of cash, for \$15,000.00. | | |

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(2) A, Capital.....	140.00	
B, Capital.....	140.00	
C, Capital.....	140.00	
Capital Adjustment Account . . .		420.00
To divide the loss on the sale.		

These entries will be followed by entries 7, 8, and 9, as in the preceding illustration.

Lump-sum sale: At a profit.—The entries to be made when a business is sold at a profit will depend upon whether the profit is regarded as a payment for goodwill or as an adjustment of the value of other assets.

Illustration: PROFIT REGARDED AS A PAYMENT FOR GOODWILL.—Assume that the assets of the firm of A, B, and C are sold to J. G. Burroughs at a lump-sum price of \$18,000.00; the entries will be:

(1) Goodwill	2,580.00	
Capital Adjustment Account		2,580.00
To take up, by charge to Goodwill, the excess of the sale price of the assets over their book value.		
(2) J. G. Burroughs, Vendee.	18,000.00	
Reserve for Depreciation—Buildings.....	800.00	
Reserve for Bad Debts.....	140.00	
Land.....		1,000.00
Buildings.....		6,000.00
Merchandise.....		4,800.00
Accounts Receivable.....		4,560.00
Goodwill.....		2,580.00
To record the sale of the assets for \$18,000.00.		
(3) Capital Adjustment Account.....	2,580.00	
A, Capital.....		860.00
B, Capital.....		860.00
C, Capital.....		860.00
To divide the profit on the sale of the business.		
(4) Cash.....	18,000.00	
J. G. Burroughs, Vendee.....		18,000.00
To record the collection from Burroughs.....		
(5) Accounts Payable.....	1,000.00	
Notes Payable.....	500.00	
Cash.....		1,500.00
To record the payment of the liabilities.		
(6) A, Capital.....	6,960.00	
B, Capital.....	5,960.00	
C, Capital.....	3,860.00	
Cash.....		16,780.00
To record the final distribution of cash to the partners.		

Illustration: PROFIT REGARDED AS AN ADJUSTMENT OF ASSET VALUES.—The fact that the assets were sold for more than their book value is not conclusive evidence of the existence of a goodwill. The excess price may have been due to the fact that the book values of the assets were understated. On this assumption, the entries for the sale of the assets for \$18,000.00 will be as follows:

(1) J. G. Burroughs, Vendee.....	18,000.00	
Reserve for Depreciation—Buildings..	800.00	
Reserve for Bad Debts.....	140.00	
Land.....		1,000.00
Buildings.....		6,000.00
Merchandise.....		4,800.00
Accounts Receivable.....		4,560.00
Capital Adjustment Account.....		2,580.00
To record the sale of the assets, exclusive of cash, for \$18,000.00.		

This entry will be followed by entries 3, 4, 5, and 6, as in the immediately preceding illustration.

Transfer of liabilities.—If the purchaser assumes the liabilities, the entry transferring the assets will be followed by an entry transferring the liabilities, as follows:

Accounts Payable.....	1,000.00	
Notes Payable.....	500.00	
J. G. Burroughs, Vendee.....		1,500.00
To record the assumption of our liabilities by the purchaser of the assets.		

When the liabilities are assumed by the purchaser of a business, the seller is not relieved from liability unless the creditors release him.

Division of profit or loss on sale.—It cannot be too strongly emphasized that the agreed profit and loss ratio governs the division of gains or losses arising from the sale of a partnership's assets. Any agreement which the partners have made in regard to profits applies with equal force to losses, and the agreement concerning the sharing of profits or losses during operations applies also to profits or losses during liquidation, when the partnership is selling its assets and going out of business.

It is an error to assume that losses incurred at the dissolution of a partnership should be divided in the capital ratio.

One writer has stated that such losses should be divided in the capital ratio and has supported this statement by the argument that when the partners decide to go out of business the partnership is dissolved, the partnership agreement is no longer binding, and, thereafter, losses are losses of capital and should be borne in the capital ratio.

There are several answers to this argument. In the first place, all losses are losses of capital. If operations result in a loss, the capital of the partners is reduced; but the loss is borne in the profit and loss ratio.

In the second place, the partnership is not dissolved merely by the decision to sell the business or to discontinue operations. The partners have placed their assets in a common fund for common operations, and they continue to be partners until the business is sold or the assets are realized. Any losses on sale or realization are therefore partnership losses, and the agreement concerning the division of partnership losses governs their division.

In the third place, the profits or losses from operations which have been divided in the agreed ratio are merely periodical estimates; the true profit or loss on the partnership venture is not definitely determinable until the partnership is dissolved and the partnership fund is distributed among the partners. The depreciation, which affected the statement of operating profits, may have been incorrect; the provision for bad debts may have been incorrect; other assets may have been incorrectly valued. All of these things have affected the profits which have been divided in the profit and loss ratio; the loss or gain disclosed at dissolution is in a sense a correction of all of these errors, and it also should be divided in the profit and loss ratio.

In the fourth place, the agreement with respect to sharing of profits and losses is an unqualified agreement. Since the agreement is not expressly limited to operating profits or losses, it is incorrect to imply any such limitation.

Incorporation of a Partnership

Classification of cases.—The accounting procedure to be followed when a partnership is changed to a corporation, will depend upon whether the partnership's books are to be used by the corporation, and whether it is desired to show the

division of stock among the partners. The typical cases may therefore be classified as follows:

- (A) Partnership books retained for use by the corporation.
- (B) New books to be used by the corporation.
 - (1) Stock distribution not shown on partnership books.
 - (a) Agreed values of assets shown on partnership books.
 - (b) Agreed values of assets not shown on partnership books.
 - (2) Stock distribution shown on partnership books.

Journal entries illustrating these typical cases are given on the following pages.

Basis of illustration.—It will be assumed that *A* and *B* are in partnership, sharing profits and losses equally. They decide to incorporate, and with this object in view they close their books and draw off the following balance sheet:

A AND B	
Balance Sheet—December 31, 1933	
Assets	
Land.....	\$ 2,000.00
Buildings.....	\$7,500.00
Less Reserve for Depreciation.....	1,500.00
	6,000.00
Merchandise.....	5,900.00
Accounts Receivable.....	\$2,100.00
Less Reserve for Bad Debts.....	200.00
	1,900.00
Cash.....	200.00
	\$16,000.00
Liabilities	
Accounts Payable.....	\$ 1,000.00
Notes Payable.....	600.00
<i>A</i> , Capital.....	6,000.00
<i>B</i> , Capital.....	8,400.00
	\$16,000.00

The assets are to be taken over by the corporation at the following values:

Land.....	\$2,500.00
Buildings.....	6,500.00
Merchandise.....	5,900.00
Accounts Receivable.....	1,800.00
Cash.....	200.00
Goodwill.....	1,700.00

Partnership books retained.—If the partnership books are to be retained for use by the corporation, it is not necessary to close the partnership books. The only necessary entries are:

- Entries to adjust the asset values.
- Entries to close the partners' capitals and open a Capital Stock account.

These entries are given below:

(1) Land.....	500.00	
Capital Adjustment Account . . .		500.00
To write up the land to \$2,500.00.		
(2) Reserve for Depreciation.....	500.00	
Capital Adjustment Account.....		500.00
To reduce the depreciation reserve		
\$500.00 in order to increase the carry-		
ing value of the building from		
\$6,000.00 to the agreed amount of		
\$6,500.00.		
(3) Capital Adjustment Account.....	100.00	
Reserve for Bad Debts.....		100.00
To reduce the carrying value of		
accounts receivable from \$1,900.00		
to \$1,800.00.		
(4) Goodwill.....	1,700.00	
Capital Adjustment Account . . .		1,700.00
To place the agreed goodwill on the		
books.		
(5) Capital Adjustment Account.....	2,600.00	
A, Capital.....		1,300.00
B, Capital.....		1,300.00
To divide the net increase in the		
asset values.		
(6) A, Capital.. . . .	7,300.00	
B, Capital.. . . .	9,700.00	
Capital Stock.....		17,000.00
To close the partners' Capital ac-		
counts and open the Capital Stock		
account.		

New corporation books : Stock distribution not shown.—If new books are to be opened by the corporation, the partnership books will be closed. The procedure of closing the partnership books will depend upon whether or not it is desired to show on the partnership books the adjusted values

at which the assets are transferred to the corporation. Both procedures are illustrated below.

Illustration: ADJUSTED ASSET VALUES NOT SHOWN ON PARTNERSHIP BOOKS.—The only entry necessary is one closing all of the accounts, as follows:

Accounts Payable	1,000.00	
Notes Payable	600.00	
Reserve for Depreciation—Buildings	1,500.00	
Reserve for Bad Debts	200.00	
A, Capital	6,000.00	
B, Capital	8,400.00	
Land		2,000.00
Buildings		7,500.00
Merchandise		5,900.00
Accounts Receivable		2,100.00
Cash		200.00
To close all of the accounts on the partnership books.		

Illustration: ADJUSTED ASSET VALUES SHOWN ON PARTNERSHIP BOOKS.—Entries 1 to 5, inclusive, in the illustration in the section on “Partnership books retained” should be made on the partnership books. The closing of the books can then be completed by the following entry:

A, Capital	7,300.00	
B, Capital	9,700.00	
Accounts Payable	1,000.00	
Notes Payable	600.00	
Reserve for Depreciation	1,000.00	
Reserve for Bad Debts	300.00	
Goodwill		1,700.00
Land		2,500.00
Buildings		7,500.00
Merchandise		5,900.00
Accounts Receivable		2,100.00
Cash		200.00
To close all accounts on the partnership books.		

New corporation books: Stock distribution shown.—If the partnership books are to show the stock received from the corporation and the distribution of this stock to the partners, it is necessary to make entries adjusting the asset accounts to the agreed values. After the asset and Capital accounts are adjusted, it is customary to record the transfer of the assets and the liabilities by entries similar to those already described for the sale of a business. These entries may be

summarized as follows:

Adjustment of asset values and capitals.

Transfer of assets, charging the corporation in a Vendee account.

Transfer of liabilities, crediting the corporation Vendee account.

Receipt of stock from the corporation.

Distribution of stock to the partners.

Returning to the illustration, the first five entries in the illustration in the section on "Partnership books retained" would be repeated here, to adjust the asset and Capital accounts. The remaining entries would be:

The A and B Company, Vendee...	18,600.00	
Reserve for Depreciation—Buildings	1,000.00	
Reserve for Bad Debts	300.00	
Goodwill		1,700.00
Land		2,500.00
Buildings		7,500.00
Merchandise		5,900.00
Accounts Receivable		2,100.00
Cash		200.00
To record the transfer of the partnership's assets to The A and B Company, at the agreed values, and in accordance with the contract of sale, dated December 31, 1933.		
Accounts Payable	1,000.00	
Notes Payable	600.00	
The A and B Company, Vendee		1,600.00
To record the assumption of our liabilities by the corporation.		
Stock of The A and B Company	17,000.00	
The A and B Company, Vendee		17,000.00
To record the receipt of stock of the corporation in payment for the net assets transferred, as follows:		
Assets	18,600.00	
Less liabilities	1,600.00	
Stock received for net assets	<u>17,000.00</u>	
A, Capital	7,300.00	
B, Capital	9,700.00	
Stock of The A and B Company		17,000.00
To record the distribution of stock between the partners.		

Entries on the corporation's books.—The corporation's books should be opened by entries for:

Subscriptions.

Purchase of the assets.

Assumption of the liabilities.

Offset of partners' liability to corporation (for subscriptions) against corporation's liability to partners (for net assets).

The entries to appear on the corporation's books are:

Subscriptions.....	17,000.00	
Capital Stock.....		17,000.00
To record the subscription to our entire authorized capital stock as follows:		
<i>A</i>	7,300.00	
<i>B</i>	9,700.00	
Total.....	<u>17,000.00</u>	
Goodwill.....	1,700.00	
Land.....	2,500.00	
Buildings.....	7,500.00	
Merchandise.....	5,900.00	
Accounts Receivable.....	2,100.00	
Cash.....	200.00	
Reserve for Depreciation—Buildings.....		1,000.00
Reserve for Bad Debts.....		300.00
<i>A</i> and <i>B</i> , Vendors.....		18,600.00
To record the purchase of the assets of the firm of <i>A</i> and <i>B</i> , in accordance with the contract dated December 31, 1933. See minutes of directors' meeting, page 3. Payment to be made as follows:		
Assets acquired.....	18,600.00	
Liabilities assumed.....	1,600.00	
Payment in stock for net assets.....	<u>17,000.00</u>	
<i>A</i> and <i>B</i> , Vendors.....	1,600.00	
Accounts Payable.....		1,000.00
Notes Payable.....		600.00
To record the assumption of the liabilities of the partnership, in accordance with the terms stated in the preceding entry.		
<i>A</i> and <i>B</i> , Vendors.....	17,000.00	
Subscriptions.....		17,000.00
To offset our liability to the partnership for net assets transferred to us, against the liability of the partners to the corporation for subscriptions.		

CHAPTER 34

PARTNERSHIPS (Continued)

Liquidation

Liquidation.—In its narrower sense, liquidation means the payment of a liability. But in its broader sense, liquidation means the process of winding up a business, converting the assets into cash, paying the liabilities, and distributing the remaining cash among the partners or stockholders. While this process is going on, a business is said to be in liquidation.

Realization.—Realization is the process of converting assets into cash. It is an incorrect use of accounting terminology to speak of liquidating assets. Assets are realized; liabilities are liquidated.

Recording liquidation.—The process of liquidating a partnership requires entries to record the following facts:

Realization of the assets.

Division of the loss or gain on realization, by charges or credits to the partners' capitals.

Payment of the liabilities.

Payment of the partners' interests.

Order of distribution of cash.—As a general rule the cash should be distributed in the following order:

To outside creditors.

To partners for any loan accounts.

To partners for capital accounts.

This rule has some exceptions, which will be discussed in subsequent sections.

Distribution of loss or gain.—There is one invariable rule which should be followed in partnership liquidations. *Any known loss or gain on realization should be recorded in*

the partners' accounts before any payments are made to the partners. Put in another way, the rule may be stated as follows: Always distribute the loss or gain before distributing the cash.

This rule cannot be too strongly emphasized, for it is frequently ignored and serious errors are thereby caused. The amount to which a partner is entitled when the business is liquidated, depends upon:

- His capital contribution.
- His loans to the firm.
- His drawings.
- His share of the profit or loss.

Unless all of these factors are taken into consideration, it is impossible to tell what a partner's equity is and what amount should be paid to him.

Typical cases.—The illustrations in this chapter and in Chapter 35, while not embracing all possible cases of partnership liquidation, are fairly inclusive and show the principles involved in typical problems of partnership liquidation.

In every case in this chapter, it is assumed that no payments are made to the partners until all of the assets have been realized and the loss on realization has thus been fully determined. The cases in Chapter 35 are based on the assumption that payments are made to the partners before the assets have been fully realized and the loss ascertained.

Case 1.—This case illustrates the following conditions:

- Realization of assets completed before payments are made to partners.
- Losses not sufficient to exhaust any partner's capital.
- No loans from partners.

The following is a condensed trial balance of a partnership before realization and liquidation:

<i>D</i> , Capital		\$20,000.00
<i>E</i> , Capital		10,000.00
Assets	\$35,000.00	
Liabilities		5,000.00
	<u>\$35,000.00</u>	<u>\$35,000.00</u>

Profits and losses are shared equally. The assets are sold for \$29,000.00 cash. Following are the journal entries recording the realization and liquidation.

Cash	29,000.00	
D, Capital.....	3,000.00	
E, Capital.....	3,000.00	
Assets.....		35,000.00
To record the sale of the assets and the distribution of the loss of \$6,000.00.		
Liabilities.....	5,000.00	
Cash.....		5,000.00
To record the payment of the liabilities.		
D, Capital.....	17,000.00	
E, Capital.....	7,000.00	
Cash.....		24,000.00
To record the final distribution to the partners in settlement of their capitals, as follows:		
	<u>D</u>	<u>E</u>
Capitals before sale.....	20,000.00	10,000.00
Loss on realization.....	3,000.00	3,000.00
Cash.....	<u>17,000.00</u>	<u>7,000.00</u>

The facts with regard to this liquidation may be set up in statement form in the following manner:

Statement of Liquidation

	<u>Assets</u>	<u>D, Capital</u>	<u>E, Capital</u>	<u>Lia- bilities</u>
Balances before realization.....	\$35,000	\$20,000	\$10,000	\$5,000
Loss on realization.....	6,000	<u>3,000</u>	<u>3,000</u>	
Cash for division.....	<u>\$29,000</u>			
Capital balances after realization.....		\$17,000	\$7,000	
Payment of creditors.....	5,000			<u>5,000</u>
Payment to partners.....	<u>\$24,000</u>	<u>17,000</u>	<u>7,000</u>	

It is usually sufficient to submit a statement of the partners' Capital accounts, for it is assumed that the liabilities are paid in full. Such a statement of the Capital accounts would appear as follows:

D AND E
Statement of Capital Accounts

	<u>D</u>	<u>E</u>	<u>Together</u>
Capitals before realization.....	\$20,000.00	\$10,000.00	\$30,000.00
Deduct loss on realization.....	3,000.00	3,000.00	6,000.00
Balances paid in cash.....	<u>\$17,000.00</u>	<u>\$ 7,000.00</u>	<u>\$24,000.00</u>

Wrong methods.—The necessity of charging off the loss on realization before dividing the cash between the partners has already been emphasized. Students seem prone to overlook this rule and to make one of the following errors:

- (1) Dividing the cash in the profit and loss ratio.
- (2) Dividing the cash in the original capital ratio.

DIVIDING THE CASH IN THE PROFIT AND LOSS RATIO.—The following statement (based on the preceding illustration) shows the effect of dividing the cash in the profit and loss ratio, instead of dividing the loss in the profit and loss ratio:

<i>D AND E</i>			
Statement of Capital Accounts			
	<u><i>D</i></u>	<u><i>E</i></u>	<u>Together</u>
Capitals before realization....	\$20,000.00	\$10,000.00	\$30,000.00
Cash (in P. & L. ratio).....	12,000.00	12,000.00	24,000.00
Remaining balances.....	Cr. <u>\$ 8,000 00</u>	Dr. <u>\$ 2,000.00</u>	<u>\$ 6,000 00</u>

This division of the cash makes *D* bear a loss of \$8,000.00, while *E* actually gains \$2,000.00; the loss of \$6,000.00 should have been borne equally.

DIVIDING THE CASH IN THE ORIGINAL CAPITAL RATIO.—The following statement shows the effect of dividing the cash in the original capital ratio, instead of first charging off the loss and then paying the partners their resulting balances:

<i>D AND E</i>			
Statement of Capital Accounts			
	<u><i>D</i></u>	<u><i>E</i></u>	<u>Together</u>
Capitals before realization.....	\$20,000.00	\$10,000.00	\$30,000 00
Cash (in original capital ratio).....	16,000.00	8,000.00	24,000.00
Remaining balances.....	<u>\$ 4,000.00</u>	<u>\$ 2,000.00</u>	<u>\$ 6,000.00</u>

This incorrect procedure results in dividing the loss in the capital ratio instead of dividing it equally, as agreed.

Case 2.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Losses not sufficient to exhaust any partner's capital.

A loan from a partner.

The following is a condensed trial balance of a partnership prior to dissolution:

<i>G</i> , Capital.....		\$15,000.00
<i>H</i> , Capital.....		10,000.00
<i>G</i> , Loan.....		5,000.00
Assets.....	\$35,000.00	
Liabilities.....		5,000.00
	<u>\$35,000.00</u>	<u>\$35,000.00</u>

The assets are sold for \$30,000.00. Since nothing is said concerning the profit and loss ratio, it must be assumed that profits and losses are shared equally. The liquidation is shown below:

Statement of Liquidation

	<u>Lia- bilities</u>	<u><i>G</i>, Loan</u>	<u><i>G</i>, Capital</u>	<u><i>H</i>, Capital</u>
Balances before realization.....	\$5,000	\$5,000	\$15,000	\$10,000
Loss on realization.....			2,500	2,500
Capital balances after realization.....			<u>\$12,500</u>	<u>\$ 7,500</u>
Distribution of cash:				
Liabilities.....	5,000			
<i>G</i> , Loan.....		5,000		
Partners' capitals.....			<u>12,500</u>	<u>7,500</u>

This case illustrates the general rule that cash distributions should be made in the following order of priority: (1) to outside creditors, in payment of liabilities; (2) to partners, in payment of loans from them; and (3) to partners, in liquidation of their capital investments. However, this rule is subject to certain exceptions, which are illustrated in subsequent cases.

Case 3.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership solvent and able to pay its creditors in full.

Two partners; one partner has a debit balance in his Capital account after realization; the other partner has a credit balance. No partners' loans.

The illustration is based on the following condensed trial balance showing the condition before the realization of the assets.

PARTNERSHIPS

<i>I</i> , Capital.....		\$15,000.00	
<i>J</i> , Capital.....			3,000.00
Assets.....	\$30,000.00		
Liabilities.....			12,000.00
		<u>\$30,000.00</u>	<u>\$30,000.00</u>

Profits and losses are shared equally. The assets realize \$22,000.00.

Statement of Liquidation

	<u>Liabilities</u>	<u><i>I</i>, Capital</u>	<u><i>J</i>, Capital</u>
Balances before realization	\$12,000.00	\$15,000.00	\$3,000.00
Loss on realization		4,000.00	4,000.00
Capitals after realization.....		\$11,000.00	\$1,000.00*
Distribution of cash:			
Liabilities.....	12,000.00		
<i>I</i> , Capital.....		10,000.00	
Balances.....		\$ 1,000.00	\$1,000.00*

* Debit balance.

In fulfillment of his agreement to bear one half of any loss, *J* should pay *I* the \$1,000.00 balance of his account. Otherwise *I* will bear \$5,000.00 of the Loss and *J* will bear only \$3,000.00.

Case 4.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership solvent and able to pay its creditors in full.

Two partners; one partner has a debit balance in his Capital account after realization; the other partner has a credit balance. Both partners have Loan accounts with credit balances.

The credit balance in a partner's Loan account should not be paid to him in full if there is a debit balance in his Capital account. The debit balance in the Capital account represents a debt owed by the partner to the partnership; the credit balance in the Loan account represents a debt owed by the partnership to the partner. Enough of the loan should be transferred to the Capital account to make good the debit balance in the Capital account, and only the remainder of the loan should be paid to the partner. This is called exercising the right of offset.

If the entire credit balance in the Loan account were

paid to the partner, without making any offset, the partner might refuse, or be unable, to pay in the debit balance of his Capital account.

The entire loan should not be transferred to the Capital account. Loans take precedence over capitals and should be paid before the capitals. If the entire loan were transferred to the Capital account, the priority of the unapplied balance of the loan would be disregarded.

X and Y share profits in the ratio of 70% and 30%, respectively. Their trial balance prior to realization was:

X, Capital.....		\$20,000.00
Y, Capital.....		18,000.00
Assets	\$87,000.00	
Liabilities		15,000.00
X, Loan.....		10,000.00
Y, Loan.....		24,000.00
		<u>\$87,000.00</u> <u>\$87,000.00</u>

The assets were sold for \$55,000.00. Following are the journal entries to record the realization and liquidation:

Cash.....	55,000.00	
X, Capital.....	22,400.00	
Y, Capital.....	9,600.00	
Assets.....		87,000.00
To record the sale of assets, having a book value of \$87,000.00, for \$55,000.00, the resulting loss of \$32,000.00 being divided between the partners in their profit and loss ratio of 70 % and 30 %.		
Liabilities.....	15,000.00	
Cash.....		15,000.00
To record the payment of the liabilities.		
X, Loan.....	2,400.00	
X, Capital.....		2,400.00
To exercise the right of offset, making good from X's Loan account the deficit in his Capital account caused by:		
Loss on realization.....	22,400.00	
Capital before realization.....	20,000.00	
Debit balance.....	<u>2,400.00</u>	
X, Loan.....	7,600.00	
Y, Loan.....	24,000.00	
Cash.....		31,600.00
To record the payment of the partners' loans.		
Y, Capital.....	8,400.00	
Cash.....		8,400.00
To record the payment of Y's capital.		

The settlement could be shown in statement form as follows:

Statement of Liquidation						
	Assets	Liabilities	X, Loan	Y, Loan	X, Capital	Y, Capital
Balances before realization.....	\$87,000	\$15,000	\$10,000	\$24,000	\$20,000	\$18,000
Loss on realization....	32,000				22,400	9,600
Balances after realization.....	\$55,000	\$15,000	\$10,000	\$24,000	\$ 2,400*	\$ 8,400
Offset against loan....			2,400		2,400	
Balances after offset..	<u>\$55,000</u>	<u>\$15,000</u>	<u>\$ 7,600</u>	<u>\$24,000</u>	<u>\$ —</u>	<u>\$ 8,400</u>
Distribution of cash:						
Liabilities.....	\$15,000	15,000				
Partners' loans....	31,600		7,600	24,000		
Partner's capital...	8,400					8,400
Total cash.....	<u>\$55,000</u>					

* Capital deficit.

Case 5.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership solvent and able to pay its creditors in full.

Three partners, one with a debit balance in his Capital account after realization. No partners' loans.

This case is intended to illustrate the procedure to be followed when there are three or more partners, one of whom has a Capital account which has been reduced to a debit balance by losses. In such a situation, it will be impossible to pay in full the partners who have credit balances, unless the partner with a debit balance pays in the amount thereof. But suppose that it is desired to distribute the cash on hand before the partner with a debit balance pays in the amount thereof, and before it is known whether he will be able to do so. The question is: How should the cash be divided?

The important thing to remember is that, if the partner with a debit balance fails to pay in, this debit balance will have to be charged off as a loss. The other partners will have to bear this loss in their profit and loss ratio. Therefore the cash on hand should be distributed in such a way as to leave them with exactly the right balances to absorb the loss. In other words, the partners with credit balances should

be paid *down to* the amounts with which they would be charged if the partner with the debit balance failed to make good this balance.

To illustrate, *R*, *S*, and *T* share profits in the ratio of 50%, 30%, and 20%, respectively. After payment of their liabilities in full, preparatory to liquidation, their trial balance appears as follows:

<i>R</i> , Capital	\$10,000.00
<i>S</i> , Capital	26,100 00
<i>T</i> , Capital.	23,900.00
Assets.....	\$60,000 00
	<u>\$60,000 00</u> <u>\$60,000.00</u>

The assets are sold for \$38,000.00. The following statement shows how the \$38,000.00 should be distributed:

	Statement of Capitals			
	<u><i>R</i></u>	<u><i>S</i></u>	<u><i>T</i></u>	<u>Together</u>
Capitals before realization.	\$10,000 00	\$26,100.00	\$23,900.00	\$60,000 00
Loss on realization. . . .	11,000 00	6,600.00	4,400.00	22,000.00
Balances after realization. .	<u>\$ 1,000.00*</u>	<u>\$19,500.00</u>	<u>\$19,500.00</u>	<u>\$38,000.00</u>
Cash distributed.		18,900 00	19,100.00	38,000.00
Balances after distribution. .	<u>\$ 1,000.00*</u>	<u>\$ 600.00</u>	<u>\$ 400.00</u>	

* Indicates debit balance.

The payments made to *S* and *T* were determined thus: The profit and loss ratio is: *R*, 50%; *S*, 30%; and *T*, 20%. If *R* fails to pay in his debit balance of \$1,000.00, the loss will have to be divided between *S* and *T* in their ratio of 30 and 20, or three fifths and two fifths. Therefore *S* is paid down to three fifths of \$1,000.00, or \$600.00; and *T* is paid down to two fifths of \$1,000.00, or \$400.00. If *R* fails to pay in the \$1,000.00, *S* and *T* will have balances in their accounts exactly equal to the losses with which they will be charged; if *R* does pay in the \$1,000.00, *S* will be paid \$600.00 and *T* will be paid \$400.00.

Wrong methods.—Problems of this type are frequently solved by actually charging off the debit balance and setting up a statement like the one on the following page.

This method results in the same cash distribution as the correct method. The error lies in actually charging off *R*'s debit balance before it is known positively that *R* will not pay it in.

PARTNERSHIPS

Statement of Capitals

	<u>R</u>	<u>S</u>	<u>T</u>	<u>To- gether</u>
Capitals before realization..	\$10,000	\$26,100	\$23,900	\$60,000
Loss on realization.....	11,000	6,600	4,400	22,000
Balances after realization..	\$ 1,000*	\$19,500	\$19,500	\$38,000
Debit balance charged off... Cr.	1,000	Dr. 600	Dr. 400	
Resulting balances.....	—	\$18,900	\$19,100	\$38,000
Cash distributed.....		18,900	19,100	38,000

* Debit balance.

Another wrong method is to pay the partners who have credit balances in the ratio of these credit balances. Thus:

Statement of Capitals

	<u>R</u>	<u>S</u>	<u>T</u>	<u>Together</u>
Capitals before realization.	\$10,000.00	\$26,100.00	\$23,900.00	\$60,000.00
Loss on realization.....	11,000.00	6,600.00	4,400.00	22,000.00
Balances after realization..	\$ 1,000.00*	\$19,500.00	\$19,500.00	\$38,000.00
Cash distributed.....		19,000.00	19,000.00	38,000.00
Resulting balances.....	\$ 1,000.00*	\$ 500.00	\$ 500.00	

* Debit balance.

In this statement, the cash is divided equally because the capital balances of *S* and *T* are equal after the realization loss is charged off. But this procedure is incorrect. If *R*'s account cannot be collected from him, *S* will be charged with \$600.00 although he has only \$500.00 in his account, and *T* will be charged with \$400.00 although he has \$500.00 in his account. *T* will then have to try to collect \$100.00 from *S*, which he may not be able to do.

Case 6.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership insolvent and unable to pay its creditors in full.

Two partners, both with debit balances in their Capital accounts after realization. No partners' loans.

Assume the following trial balance before realization:

<i>K</i> , Capital.....		\$ 3,000.00
<i>L</i> , Capital.....		2,000.00
Accounts Payable.....		20,000.00
Assets.....	\$25,000.00	
	<u>\$25,000.00</u>	<u>\$25,000.00</u>

Profits and losses are shared equally. The assets are sold for \$17,000.00.

Statement of Liquidation

	<u>Liabilities</u>	<u>K, Capital</u>	<u>L, Capital</u>
Balances before realization.....	\$20,000.00	\$3,000.00	\$2,000.00
Loss on realization.....		4,000.00	4,000.00
Resulting balances	<u>\$20,000.00</u>	<u>\$1,000.00*</u>	<u>\$2,000.00*</u>
Cash payments to creditors.....	17,000.00		
Final balances.....	<u>\$ 3,000.00</u>	<u>\$1,000.00*</u>	<u>\$2,000.00*</u>

* Debit balance.

The creditors have a claim against the partners for the \$3,000.00 of unpaid liabilities. It is not necessary that they consider the debit balances of the two partners; that is, they have the right to enforce collection in full from either of the partners. Assuming that the creditors collect the entire amount from *K*, an entry should be made debiting the liability accounts and crediting *K*'s capital. Continuing the statement:

	<u>Liabilities</u>	<u>K, Capital</u>	<u>L, Capital</u>
Balances—as above.....	\$3,000.00	\$1,000.00*	\$2,000.00*
Liabilities paid by <i>K</i>	Dr. <u>3,000.00</u>	Cr. <u>3,000.00</u>	
Resulting balances.....	—	<u>\$2,000.00</u>	<u>\$2,000.00*</u>

* Debit balance.

K, who now has a credit balance of \$2,000.00, has a claim against *L* for this amount.

Case 7.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership insolvent and unable to pay its creditors in full.

Some partners have debit balances and others have credit balances after charging off losses on realization. No partners' loans.

It is possible for one or more partners to have credit balances in their Capital accounts, even though the partnership is insolvent; but at least one of the partners will, in that case, have a debit balance exceeding the sum of the credit balances. To illustrate, *P*, *Q*, and *R* draw off the following trial balance preparatory to liquidation:

PARTNERSHIPS

<i>P</i> , Capital.....		\$ 3,000.00
<i>Q</i> , Capital.		8,000.00
<i>R</i> , Capital.		9,000.00
Liabilities.....		20,000.00
Assets.....	\$40,000.00	
	<u>\$40,000.00</u>	<u>\$40,000.00</u>

Profits and losses are shared equally. The assets are sold for \$19,000.00. Following is the statement showing the liquidation:

Liquidation Statement

	<u>Liabilities</u>	<u><i>P</i>, Capital</u>	<u><i>Q</i>, Capital</u>	<u><i>R</i>, Capital</u>
Balances before realization . . .	\$20,000.00	\$3,000.00	\$8,000.00	\$9,000.00
Loss on realization.....		7,000.00	7,000.00	7,000.00
Balances after realization.....	<u>\$20,000.00</u>	<u>\$4,000.00*</u>	<u>\$1,000.00</u>	<u>\$2,000.00</u>
Cash payments to creditors... ..	19,000.00			
Final balances.....	<u>\$ 1,000.00</u>	<u>\$4,000.00*</u>	<u>\$1,000.00</u>	<u>\$2,000.00</u>

* Debit balance.

In accordance with the partnership agreement concerning the sharing of profits and losses, *P* should pay in the \$4,000.00 debit balance of his account. If he does so, the \$4,000.00 will be sufficient to pay the creditors and the other two partners. But the creditors are not bound by the partnership agreement, and may attempt to enforce payment from any partner. Various conditions may therefore develop, some of which are illustrated below.

(1) *P* pays in the \$4,000.00 debit balance in his account.

	<u>Liabilities</u>	<u><i>P</i>, Capital</u>	<u><i>Q</i>, Capital</u>	<u><i>R</i>, Capital</u>
Balances—as above.....	\$1,000 Cr.	\$4,000 Dr.	\$1,000 Cr.	\$2,000 Cr.
<i>P</i> pays in.....		<u>4,000 Cr.</u>		
Final cash payments.....	<u>1,000 Dr.</u>		<u>1,000 Dr.</u>	<u>2,000 Dr.</u>

(2) The creditors collect \$1,000.00 from *P*, and no further collections are received from him.

	<u>Liabilities</u>	<u><i>P</i>, Capital</u>	<u><i>Q</i>, Capital</u>	<u><i>R</i>, Capital</u>
Balances—as above.....	\$1,000 Cr.	\$4,000 Dr.	\$1,000 Cr.	\$2,000 Cr.
<i>P</i> pays creditors.....	<u>1,000 Dr.</u>	1,000 Cr.		
<i>P</i> 's account written off.....		<u>3,000 Cr.</u>	<u>1,500 Dr.</u>	<u>1,500 Dr.</u>
Balances.....			<u>\$ 500 Dr.</u>	<u>\$ 500 Cr.</u>

Q should pay *R* \$500.00.

- (3) The creditors collect \$1,000.00 from *Q*, and it is impossible to make any collection from *P*.

	<u>Liabilities</u>	<u><i>P</i>, Capital</u>	<u><i>Q</i>, Capital</u>	<u><i>R</i>, Capital</u>
Balances—as above.....	\$1,000 Cr.	\$4,000 Dr.	\$1,000 Cr.	\$2,000 Cr.
<i>Q</i> pays creditors.....	<u>1,000 Dr.</u>		1,000 Cr.	
<i>P</i> 's account written off.....		<u>4,000 Cr.</u>	<u>2,000 Dr.</u>	<u>2,000 Dr.</u>

Case 8.—This case illustrates the following conditions:

Realization of assets completed before payments are made to partners.

Partnership insolvent and unable to pay its creditors in full.

One or more partners insolvent.

This case is intended to explain the legal rights of creditors of an insolvent partnership and the rights of creditors of an insolvent partner. The legal rules which apply may be stated as follows:

The creditors of the partnership have a right to be paid in full from the firm assets, before the creditors of the individual partners have any claim against the firm assets.

After the firm creditors have been paid, the creditors of a partner with a credit balance may have recourse against his partnership interest to the extent of such credit balance.

The creditors of a partner have a right to be paid in full from his private assets before the creditors of the firm have any claim against these assets.

After a partner's personal creditors have been paid, the creditors of the partnership have access to the residue of his assets regardless of whether he has a credit or a debit balance, provided the firm creditors have already exhausted the firm assets.

These rules may be summarized as follows:

The partnership assets must be applied first to the payment of partnership debts, and each partner's separate

estate must be applied first to the payment of his own creditors.

To illustrate, assume that *A*, *B*, and *C*, sharing profits and losses equally, draw off the following trial balance preparatory to liquidation:

<i>A</i> , Capital.....	\$ 5,000.00	
<i>B</i> , Capital.....	14,000.00	
<i>C</i> , Capital.....	1,000.00	
Liabilities.....	40,000.00	
Assets.....	\$60,000.00	
	<u>\$60,000.00</u>	<u>\$60,000.00</u>

The assets are sold for \$36,000.00. The liquidation statement shows the distribution of the loss, and the partial payment of the partnership creditors, as follows:

Liquidation Statement

	Liabilities	<i>A</i> , Capital	<i>B</i> , Capital	<i>C</i> , Capital
Balances before realization.....	\$40,000	\$5,000	\$14,000	\$1,000
Loss on realization (\$24,000.00)		8,000	8,000	8,000
Balances after realization.....	\$40,000	\$3,000*	\$ 6,000	\$7,000*
Payment of creditors.....	36,000			
Final balances.....	\$ 4,000	\$3,000*	\$ 6,000	\$7,000*

* Debit balance.

An investigation of the partners' personal balance sheets discloses the following information:

	Assets	Liabilities
<i>A</i>	\$ 1,000.00	\$ 1,000.00
<i>B</i>	2,000.00	10,000.00
<i>C</i>	15,000.00	1,000.00

Further rights of partnership creditors.—The partnership creditors, who have had all of the firm assets applied to the payment of the firm debts, and who still have claims of \$4,000.00, cannot make any collections from *A* or *B*, because the private assets of these partners are only sufficient or are insufficient to pay their personal debts. They can, however, collect the entire \$4,000.00 from *C*. It is immaterial whether *C*'s Capital account shows a debit or a credit balance. The only essential fact is that *C* will have \$14,000.00 of assets after paying his private debts. Assuming that the partnership creditors collect the \$4,000.00 from *C*, this fact would be shown on the liquidation statement as follows:

	<u>Liabilities</u>	<u>A, Capital</u>	<u>B, Capital</u>	<u>C, Capital</u>
Balances (as above)	\$4,000	\$3,000*	\$6,000	\$7,000*
Payment of liabilities by C.....	Dr. 4,000			Cr. 4,000
Resulting balances.....		<u>\$3,000*</u>	<u>\$6,000</u>	<u>\$3,000*</u>

* Debit balance.

Rights of creditors of A.—A has \$1,000.00 of personal assets and owes \$1,000.00 of liabilities to separate creditors. But, after the partnership losses are charged off, A has a debit balance of \$3,000.00 in his Capital account. This means that A is obligated to pay \$3,000.00 into the firm. This \$3,000.00 is not a partnership debt, but is a personal obligation of A to make a contribution to the firm; the obligation arose from A's profit and loss sharing agreement with his partners. Unless the \$3,000.00 contribution is made by A, his partners will bear more than their agreed shares of the loss.

According to bankruptcy and common-law decisions, A's \$1,000.00 of assets should be applied ratably toward the payment of his \$3,000.00 debt to the firm and his debts of \$1,000.00 to outsiders, as follows:

	<u>Debt</u>	<u>Payment</u>
To the firm.....	\$3,000.00	\$ 750 00
To outsiders	<u>1,000.00</u>	<u>250 00</u>
Total	<u>\$4,000.00</u>	<u>\$1,000.00</u>

However, the rule is different under the Uniform Partnership Law, in force in about half of the states, which provides that:

“Where a partner has become bankrupt or his estate is insolvent the claims against his separate property shall rank in the following order:

- I. Those owing to separate creditors.
- II. Those owing to partnership creditors.
- III. Those owing to partners by way of contribution.”

Under this rule, all of A's assets would go to his separate creditors, who would be paid in full, and no contribution would be made by A to the partnership, in payment of his \$3,000.00 debit balance.

Rights of creditors of B.—The creditors of B, after receiving

Each partner's capital is in excess of his share of possible future losses.

A, B, C, and D, sharing profits and losses equally, draw off the following trial balance, preparatory to dissolution:

<i>A</i> , Capital.....	\$15,000.00
<i>B</i> , Capital.....	13,000.00
<i>C</i> , Capital.....	12,000.00
<i>D</i> , Capital.....	10,000.00
Liabilities.....	5,000.00
Assets.....	\$55,000.00
	<u>\$55,000.00</u> <u>\$55,000.00</u>

They sell for \$24,000.00 assets carried at \$25,000.00, pay the liabilities of \$5,000.00, and have \$19,000.00 to distribute among the partners. The distribution among the partners is shown by the following statement:

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances before realization.....	\$15,000	\$13,000	\$12,000	\$10,000	\$50,000
Loss on realization	250	250	250	250	1,000
Balances	<u>\$14,750</u>	<u>\$12,750</u>	<u>\$11,750</u>	<u>\$ 9,750</u>	<u>\$49,000</u>
Cash	7,250	5,250	4,250	2,250	19,000
Balances after first distribution..	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$30,000</u>

It should be noted that the Capital accounts are now reduced to the profit and loss ratio; as the partners share profits and losses equally, the Capital accounts are reduced to equality. It was perfectly safe to distribute the cash in the manner shown, because, even if all of the \$30,000.00 of non-cash assets are lost, each partner has been left with enough capital to bear his share of the loss.

To compute the amount of cash to give to each partner, it is advisable to prepare working papers (in addition to the statement of capitals) in the following form:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Profit and loss ratio	(25%)	(25%)	(25%)	(25%)	
Total of capitals after loss.....					<u>\$49,000</u>
Cash for division.....					<u>19,000</u>
Possible loss—in P & L ratio ...	\$7,500	\$7,500	\$7,500	\$7,500	<u>\$30,000</u>

These possible losses are then entered in the capital statement in the following manner, before the cash distribution is entered:

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances before realization.....	\$15,000	\$13,000	\$12,000	\$10,000	\$50,000
Loss on realization.....	250	250	250	250	1,000
Balances.....	<u>\$14,750</u>	<u>\$12,750</u>	<u>\$11,750</u>	<u>\$ 9,750</u>	<u>\$49,000</u>
Cash.....					19,000
Balances after first distribution..	\$ 7,500	\$ 7,500	\$ 7,500	\$ 7,500	\$30,000

The cash distribution is then entered, each partner receiving enough to reduce his account to the "balance after first distribution."

Each succeeding distribution should be made in such a manner as to leave the partners' balances in their profit and loss ratio. To illustrate, suppose that two more installments are paid before the liquidation is completed, as follows:

Second installment:

Assets realized—book value.....	\$20,000.00
Loss on realization.....	2,000.00
Cash for division.....	<u>\$18,000.00</u>

Third installment:

Assets realized—book value.....	\$10,000.00
Loss on realization.....	4,000.00
Cash for division.....	<u>\$ 6,000.00</u>

The complete statement of the partners' capital accounts appears below:

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances before realization.....	\$15,000	\$13,000	\$12,000	\$10,000	\$50,000
Loss on realization.....	250	250	250	250	1,000
Balances.....	<u>\$14,750</u>	<u>\$12,750</u>	<u>\$11,750</u>	<u>\$ 9,750</u>	<u>\$49,000</u>
Cash—first distribution.....	7,250	5,250	4,250	2,250	19,000
Balances.....	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$ 7,500</u>	<u>\$30,000</u>
Loss on realization.....	500	500	500	500	2,000
Balances.....	<u>\$ 7,000</u>	<u>\$ 7,000</u>	<u>\$ 7,000</u>	<u>\$ 7,000</u>	<u>\$28,000</u>
Cash—second distribution.....	4,500	4,500	4,500	4,500	18,000
Balances.....	<u>\$ 2,500</u>	<u>\$ 2,500</u>	<u>\$ 2,500</u>	<u>\$ 2,500</u>	<u>\$10,000</u>
Loss on realization.....	1,000	1,000	1,000	1,000	4,000
Balances.....	<u>\$ 1,500</u>	<u>\$ 1,500</u>	<u>\$ 1,500</u>	<u>\$ 1,500</u>	<u>\$ 6,000</u>
Cash—third distribution.....	1,500	1,500	1,500	1,500	6,000

No partner is defrauded in any way by this method of paying in installments. This fact may be shown by assuming that no payments had been made until after the realization was

completed. The total loss and the total cash available for distribution would have been:

	<u>Loss</u>	<u>Cash for Partners</u>
First period.....	\$1,000.00	\$19,000.00
Second period.....	2,000.00	18,000.00
Third period.....	4,000.00	6,000.00
Totals.....	<u>\$7,000.00</u>	<u>\$43,000.00</u>

The distribution of the total loss and the distribution of the total available cash would have been shown in the statement of capitals as follows:

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances before realization	\$15,000	\$13,000	\$12,000	\$10,000	\$50,000
Loss on realization	<u>1,750</u>	<u>1,750</u>	<u>1,750</u>	<u>1,750</u>	<u>7,000</u>
Cash distribution.....	<u>\$13,250</u>	<u>\$11,250</u>	<u>\$10,250</u>	<u>\$ 8,250</u>	<u>\$43,000</u>

By the installment method, the partners have been charged with exactly these losses and have been paid these amounts of cash, as shown below:

Losses Charged to Partners

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
First realization.....	\$ 250.00	\$ 250.00	\$ 250.00	\$ 250.00	\$1,000.00
Second realization....	500.00	500.00	500.00	500.00	2,000.00
Third realization....	<u>1,000.00</u>	<u>1,000.00</u>	<u>1,000.00</u>	<u>1,000.00</u>	<u>4,000.00</u>
Totals (as above)..	<u>\$1,750.00</u>	<u>\$1,750.00</u>	<u>\$1,750.00</u>	<u>\$1,750.00</u>	<u>\$7,000.00</u>

Cash Distributed to Partners

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
First distribution.....	\$ 7,250	\$ 5,250	\$ 4,250	\$2,250	\$19,000
Second distribution.....	4,500	4,500	4,500	4,500	18,000
Third distribution.....	<u>1,500</u>	<u>1,500</u>	<u>1,500</u>	<u>1,500</u>	<u>6,000</u>
Totals (as above) . . .	<u>\$13,250</u>	<u>\$11,250</u>	<u>\$10,250</u>	<u>\$8,250</u>	<u>\$43,000</u>

Hence no injustice has been done.

Wrong method.—The preceding illustration shows that no injustice is done by taking the precaution of making cash distributions in such a manner as to reduce the partners' accounts to the profit and loss ratio of the remaining assets. To show what danger is incurred by failing to take this precaution, let us take another case and assume that the first distribution is made in the ratio of the capitals after the

realization loss has been charged off.

A, *B*, *C*, and *D* were partners sharing profits in the ratio of 40%, 25%, 25%, and 10%, respectively. The following trial balance was drawn off in preparation for liquidation:

<i>A</i> , Capital.....	\$24,000.00	
<i>B</i> , Capital.....	27,500.00	
<i>C</i> , Capital.....	22,500.00	
<i>D</i> , Capital.....	16,000.00	
Assets.....	<u>\$90,000.00</u>	<u>\$90,000.00</u>

Assets having a book value of \$50,000.00 were sold for \$40,000.00. The liquidator unwisely distributed the \$40,000.00 in the ratio of the capitals after charging off the \$10,000.00 loss. The statement of capitals, after the first distribution was made, appeared as follows:

Statement of Partners' Capitals

	<u><i>A</i></u>	<u><i>B</i></u>	<u><i>C</i></u>	<u><i>D</i></u>	<u>To- gether</u>
Balances before realization.....	\$24,000	\$27,500	\$22,500	\$16,000	\$90,000
Loss on realization	4,000	2,500	2,500	1,000	10,000
Balances.....	<u>\$20,000</u>	<u>\$25,000</u>	<u>\$20,000</u>	<u>\$15,000</u>	<u>\$80,000</u>
Cash—in ratio of capitals.....	10,000	12,500	10,000	7,500	40,000
Resulting balances.....	<u>\$10,000</u>	<u>\$12,500</u>	<u>\$10,000</u>	<u>\$ 7,500</u>	<u>\$40,000</u>

In distributing the \$40,000.00, the liquidator used the capital ratio after dividing the \$10,000.00 loss, and paid each partner one half of the balance at his credit. The unwisdom of this procedure became evident when it was found that only \$10,000.00 could be realized from the remaining assets. The liquidator then continued his statement as follows:

Statement of Partners' Capitals—(Continued)

	<u><i>A</i></u>	<u><i>B</i></u>	<u><i>C</i></u>	<u><i>D</i></u>	<u>To- gether</u>
Balances—as above.....	\$10,000	\$12,500	\$10,000	\$7,500	\$40,000
Loss on realization.....	12,000	7,500	7,500	3,000	30,000
Balances.....	<u>\$ 2,000*</u>	<u>\$ 5,000</u>	<u>\$ 2,500</u>	<u>\$4,500</u>	<u>\$10,000</u>

* Debit balance.

At this point *A*'s account had a debit balance of \$2,000.00, and it was necessary to collect this \$2,000.00 from *A* in order to pay the other three partners in full. But the liquidator was unable to collect the \$2,000.00, and *B*, *C*, and *D* could hold the liquidator liable for causing them this loss by paying

\$10,000.00 to A instead of holding enough of a balance in A's account to cover all possible loss on realization.

The liquidator should have safeguarded his own and the partners' interests by making the distribution as follows:

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances before realization.....	\$24,000	\$27,500	\$22,500	\$16,000	\$90,000
Loss on realization.....	4,000	2,500	2,500	1,000	10,000
Balances after realization.....	\$20,000	\$25,000	\$20,000	\$15,000	\$80,000
Cash.....	4,000	15,000	10,000	11,000	40,000
Balances in P & L ratio.....	\$16,000	\$10,000	\$10,000	\$ 4,000	\$40,000

Each partner would thus have been left with enough capital to absorb his share of the loss, even if the entire \$40,000.00 of non-cash assets had been lost. Assuming, as above, a final realization of \$10,000.00 and a loss of \$30,000.00, the final realization and distribution to the partners would be as indicated in the following statement:

Statement of Partners' Capitals—(Continued)

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Balances—as above.....	\$16,000	\$10,000	\$10,000	\$4,000	\$40,000
Loss on realization.	12,000	7,500	7,500	3,000	30,000
Balances.....	\$ 4,000	\$ 2,500	\$ 2,500	\$1,000	\$10,000
Cash.....	4,000	2,500	2,500	1,000	10,000

Case 10.—This case illustrates the following conditions:

Payments are made to partners in installments before assets are fully realized.

One partner's capital is less than his possible future loss.

If any partner's capital, before a cash distribution is made, is less than his possible loss on the assets which will remain after the distribution, it is unwise to pay him anything.

In such instances the distribution of cash installments should be made as follows:

The partner with a capital smaller than his share of a total loss should be paid nothing.

The other partners should be left with capital balances sufficient to absorb:

- (1) Their own shares of a total possible loss.
- (2) Their shares of the loss which might result from a partner's failure to pay in a debit balance.

To illustrate, assume that four partners have capitals and share profits as follows:

<u>Partner</u>	<u>Capitals</u>	<u>P & L Ratio</u>
A	\$20,000.00	25 %
B	40,000.00	20 %
C	50,000.00	25 %
D	60,000.00	30 %

All liabilities have been paid. The partnership is dissolved, and the process of realization and liquidation extends over five months, as follows:

	<u>Assets Realized</u>	<u>Loss</u>	<u>Cash to Partners</u>
First Month.....	\$50,000.00	\$10,000.00	\$40,000.00
Second Month.....	40,000.00	2,000.00	38,000.00
Third Month.....	30,000.00	4,000.00	26,000.00
Fourth Month.....	35,000.00	5,000.00	30,000.00
Fifth Month.....	15,000.00	6,000.00	9,000.00

The monthly cash distributions are computed in the following manner:

- (1) Charge off the loss on realization, and show in the statement of capitals the balance at each partner's credit after dividing the loss.
- (2) On working papers, set down the total capitals before distributing the cash; deduct the cash on hand for distribution; and thus compute the remaining non-cash assets, or total possible loss.
- (3) Indicate on the working papers the loss which would be charged to each partner in case of a total loss.
- (4) Compare each partner's capital before distributing the cash (per the statement of capitals) with his possible loss (per the working papers).
- (5) If any partner's capital is less than his possible loss, indicate on the working papers how this debit balance would be charged to the other partners in case of a total loss and in case of the partner's inability to pay the debit balance.
- (6) Add the possible losses shown in (3) and (5), and thus

ascertain the total loss each partner may be called upon to bear for himself and for an insolvent partner with a debit balance.

- (7) Enter these amounts in the statement of capitals, and pay the partners down to these balances.

If this method is applied to the present case, the partners will be charged with monthly losses and payments as indicated in the following statement:

Statement of Partners' Capitals					
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Original Balances..	\$20,000.00	\$40,000.00	\$50,000.00	\$60,000.00	\$170,000.00
First Month:					
Loss.....	2,500.00	2,000.00	2,500.00	3,000.00	10,000.00
Balances.....	<u>\$17,500.00</u>	<u>\$38,000.00</u>	<u>\$47,500.00</u>	<u>\$57,000.00</u>	<u>\$160,000.00</u>
Cash (See Working Papers)...		10,666.67	13,333.33	16,000.00	40,000.00
Balances.....	<u>\$17,500.00</u>	<u>\$27,333.33</u>	<u>\$34,166.67</u>	<u>\$41,000.00</u>	<u>\$120,000.00</u>
Second Month:					
Loss.....	500.00	400.00	500.00	600.00	2,000.00
Balances.....	<u>\$17,000.00</u>	<u>\$26,933.33</u>	<u>\$33,666.67</u>	<u>\$40,400.00</u>	<u>\$118,000.00</u>
Cash (See Working Papers)...		10,133.33	12,666.67	15,200.00	38,000.00
Balances.....	<u>\$17,000.00</u>	<u>\$16,800.00</u>	<u>\$21,000.00</u>	<u>\$25,200.00</u>	<u>\$ 80,000.00</u>
Third Month:					
Loss.....	1,000.00	800.00	1,000.00	1,200.00	4,000.00
Balances.....	<u>\$16,000.00</u>	<u>\$16,000.00</u>	<u>\$20,000.00</u>	<u>\$24,000.00</u>	<u>\$ 76,000.00</u>
Cash (See Working Papers)...	3,500.00	6,000.00	7,500.00	9,000.00	26,000.00
Balances.....	<u>\$12,500.00</u>	<u>\$10,000.00</u>	<u>\$12,500.00</u>	<u>\$15,000.00</u>	<u>\$ 50,000.00</u>
Fourth Month:					
Loss.....	1,250.00	1,000.00	1,250.00	1,500.00	5,000.00
Balances.....	<u>\$11,250.00</u>	<u>\$ 9,000.00</u>	<u>\$11,250.00</u>	<u>\$13,500.00</u>	<u>\$ 45,000.00</u>
Cash.....	7,500.00	6,000.00	7,500.00	9,000.00	30,000.00
Balances.....	<u>\$ 3,750.00</u>	<u>\$ 3,000.00</u>	<u>\$ 3,750.00</u>	<u>\$ 4,500.00</u>	<u>\$ 15,000.00</u>
Fifth Month:					
Loss.....	1,500.00	1,200.00	1,500.00	1,800.00	6,000.00
Balances.....	<u>\$ 2,250.00</u>	<u>\$ 1,800.00</u>	<u>\$ 2,250.00</u>	<u>\$ 2,700.00</u>	<u>\$ 9,000.00</u>
Cash.....	2,250.00	1,800.00	2,250.00	2,700.00	9,000.00

As each partner's capital, after the third month's loss is charged off, exceeds his possible future loss, all partners can be paid, and the partners' capitals can be reduced to the profit and loss ratio. The distributions of the fourth and fifth months are then made in the profit and loss ratio, because that is also the capital ratio.

Working Papers—First Month

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Profit and loss ratio	(25%)	(20%)	(25%)	(30%)	
Total capitals before distributing cash.....					\$160,000
Less cash for distribution...					40,000
Possible loss—P & L ratio..	\$30,000	\$24,000.00	\$30,000.00	\$36,000	<u>\$120,000</u>
Capital smaller than possible loss.....	17,500				
Additional possible loss to the other three partners .	<u>\$12,500</u>				
B— $2\frac{0}{7}_5$ of \$12,500.00...		3,333.33			
C— $2\frac{5}{7}_5$ of 12,500.00...			4,166.67		
D— $3\frac{0}{7}_5$ of 12,500.00...				5,000	
Total possible losses, or balances to which partners are paid.....		<u>\$27,333.33</u>	<u>\$34,166.67</u>	<u>\$41,000</u>	

Working Papers—Second Month

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Total capitals before distributing cash.....					\$118,000
Less cash for distribution. . . .					38,000
Possible loss—in P & L ratio..	\$20,000	\$16,000	\$20,000	\$24,000	<u>\$ 80,000</u>
Capital smaller than possible loss.....	17,000				
Additional possible loss to the other three partners.....	<u>\$ 3,000</u>				
B— $2\frac{0}{7}_5$ of \$3,000.00		800			
C— $2\frac{5}{7}_5$ of 3,000.00			1,000		
D— $3\frac{0}{7}_5$ of 3,000.00				1,200	
Total possible losses, or balances to which partners are paid. . .		<u>\$16,800</u>	<u>\$21,000</u>	<u>\$25,200</u>	

Working Papers—Third Month

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To-gether</u>
Total capitals before distributing cash.....					\$76,000
Less cash for distribution.....					26,000
Possible loss—in P & L ratio...	\$12,500	\$10,000	\$12,500	\$15,000	<u>\$50,000</u>

Case 11.—This case illustrates the following conditions:

Payments are made to partners in installments before assets are fully realized.

Two partners' capitals are less than their possible future losses.

This illustration involves no new principles. It merely shows how the safeguard principle is applied when two partners have capitals which are less than their shares of a possible future loss. Since no new principle is involved, the illustration is limited to the distribution of the first installment.

Given the following facts:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	
Capitals before realization	\$40,000	\$60,000	\$70,000	\$30,000	
Profit and loss ratio.	30 %	20 %	40 %	10 %	
All liabilities paid.					
Book value of assets sold the first month					\$30,000
Loss on realization					6,000
Cash for distribution					<u>\$24,000</u>

Required: a statement of the partners' capitals showing the distribution of the \$24,000.00, and working papers showing the computation of the amounts paid to each partner.

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Capitals before realization	\$40,000	\$60,000	\$70,000	\$30,000	\$200,000
Loss on realization	1,800	1,200	2,400	600	6,000
Balances after realization	\$38,200	\$58,800	\$67,600	\$29,400	\$194,000
Cash distributed		16,000		8,000	24,000
Balances after distribution	<u>\$38,200</u>	<u>\$42,800</u>	<u>\$67,600</u>	<u>\$21,400</u>	<u>\$170,000</u>

Working Papers—First Month

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Together</u>
Profit and loss ratio	(30 %)	(20 %)	(40 %)	(10 %)	
Total capitals before distributing cash					\$194,000
Less cash for distribution					24,000
Possible loss—in P & L ratio	\$51,000	\$34,000	\$68,000	\$17,000	<u>\$170,000</u>
Capitals smaller than possible loss	38,200		67,600		
Additional possible loss to B & D	<u>\$12,800</u>		<u>\$ 400</u>		<u>\$ 13,200</u>
B— $2\frac{2}{3}\%$ of \$13,200.00		8,800			
D—1% of 13,200.00				4,400	
Total possible losses, and balances to which partners are paid		<u>\$42,800</u>		<u>\$21,400</u>	

Case 12.—This case illustrates the following conditions:

Payments are made to partners in installments before

assets are fully realized.

One partner has a capital less than his possible future loss.

Another partner has a capital sufficient to bear his own share of the possible future loss, but insufficient to bear also the charge if the first partner's account is thrown into a debit balance and written off.

Given the following facts:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	
Capitals.....	\$20,000	\$29,000	\$36,000	\$15,000	
Profit and loss ratio.....	30 %	20 %	40 %	10 %	
All liabilities paid.					
Book value of assets realized					
first month.....					\$15,000
Loss on realization.....					<u>3,000</u>
Cash for distribution.....					<u>\$12,000</u>

Required: a statement of the capitals showing the distribution of the \$12,000.00, and working papers showing the computation of the amounts paid to each partner.

Working Papers—First Month

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Profit and loss ratio	(30 %)	(20 %)	(40 %)	(10 %)	
Total capitals before distributing cash.....					\$97,000
Less cash for distribution..					<u>12,000</u>
Possible loss—in P & L ratio.....	\$25,500	\$17,000.00	\$34,000.00	\$ 8,500.00	<u>\$85,000</u>
Capital smaller than possible loss.....	<u>19,100</u>				
Additional possible loss to B, C, and D.....	<u>\$ 6,400</u>				
B— $\frac{3}{4}$ of \$6,400.00...		1,828.57			
C— $\frac{1}{4}$ of 6,400.00...			3,657.14		
D— $\frac{1}{4}$ of 6,400.00...				914.29	
Totals.....	<u>\$18,828.57</u>	<u>\$37,657.14</u>	<u>\$ 9,414.29</u>		
Capital smaller than possible loss.....			<u>34,800.00</u>		
Additional possible loss to B and D.....			<u>\$ 2,857.14</u>		
B— $\frac{3}{8}$ of \$2,857.14...		1,904.76			
D— $\frac{1}{8}$ of 2,857.14...				<u>952.38</u>	
Total possible loss, and balances to which partners are paid.....	<u>\$20,733.33</u>			<u>\$10,366.67</u>	

Statement of Partners' Capitals

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>To- gether</u>
Capitals before realization . .	\$20,000	\$29,000.00	\$36,000	\$15,000.00	\$100,000
Loss on realization	900	600.00	1,200	300.00	3,000
Balances after realization . . .	\$19,100	\$28,400.00	\$34,800	\$14,700.00	\$ 97,000
Cash		7,666.67		4,333.33	12,000
Balances after distribution . .	\$19,100	\$20,733.33	\$34,800	\$10,366.67	\$ 85,000

Payment of partners' loans in installment liquidation.—

No cases have yet been considered in which partners have Loan accounts as well as Capital accounts, and in which liquidation is made in installments. In such instances the rule that partners' loans are to be paid before their capitals, does not necessarily govern. The liquidator should consider the possible future loss, and remember that, by the right of offset, losses may be charged against a partner's Loan account if his capital is not sufficient to cover his share of the loss. Hence the total possible future loss of each partner should be compared with the sum of his Capital and Loan account balances. One partner with a capital and no loan may receive a payment if his capital exceeds his possible loss; whereas another partner with a capital and a loan may receive nothing, because the sum of his capital and loan is insufficient to cover his possible loss.

If the liquidator proposes thus to make a payment on a partner's capital before making a payment on the Loan account of another partner, the partner with the Loan account may object on the basis of the general rule that partners' loans should be paid before distributions are made on capital accounts. In such an event the liquidator should explain that the proposed basis is the only one by which he can make any immediate payment without running the risk of causing one, or possibly more, of the partners to bear more than a proper share of the loss. If the partner with the loan refuses to sanction the liquidator's proposed capital payment, the liquidator should refuse to make any distributions to the partners until realization has progressed to the point at which each partner's capital (exclusive of loans) is sufficient to cover his share of the possible loss.

Case 13.—This case illustrates the following conditions:

Payments are made to partners in installments before

assets are fully realized.

Certain partners have Loan accounts.

Each partner's capital is sufficient to absorb his possible future loss.

Four partners, sharing profits and losses equally, draw off the following trial balance preparatory to liquidation:

A, Capital.....	\$18,000.00	
B, Capital.....	16,000.00	
C, Capital.....	15,000.00	
D, Capital.....	15,000.00	
C, Loan.....	3,000.00	
D, Loan.....	5,000.00	
Assets.....	\$72,000.00	
	<u>\$72,000.00</u>	<u>\$72,000.00</u>

Assets having a book value of \$22,000.00 are sold for \$20,000.00. After the loss is divided, the capitals are:

A.....	\$17,500.00
B.....	15,500.00
C.....	14,500.00
D.....	14,500.00

The non-cash assets amount to \$50,000.00, and a total loss of these assets would result in a charge of \$12,500.00 to each partner. As each partner has a Capital account balance in excess of his possible loss, the loans can be paid in full, and payments can be made on the capitals, reducing them to \$12,500.00 each.

Case 14.—This case illustrates the following conditions:

Payments are made to partners in installments before assets are fully realized.

Certain partners have loans.

One partner's total capital and loan is less than his possible future loss.

The trial balance before liquidation is:

A, Capital.....	\$25,000.00	
B, Capital.....	15,000.00	
C, Capital.....	5,000.00	
B, Loan.....	3,000.00	
C, Loan.....	7,000.00	
Assets.....	\$55,000.00	
	<u>\$55,000.00</u>	<u>\$55,000.00</u>

Profits and losses are shared equally. Assets having a book value of \$13,000.00 are sold for \$10,000.00. How should the \$10,000.00 be divided?

Although the cash on hand is exactly equal to the partners' loans of \$10,000.00, the problem cannot be dismissed by the statement that partners' loans should be paid before the capitals, and that the entire \$10,000.00 should therefore be used for the payment of the loans from *B* and *C*. It is necessary to determine the possible future loss, and pay only those partners who have capitals and loans in excess of their possible losses.

Working Papers

	<u>A</u>	<u>B</u>	<u>C</u>	<u>To- gether</u>
	($\frac{1}{3}$)	($\frac{1}{3}$)	($\frac{1}{3}$)	
Profit and Loss ratio				
Capitals—per trial balance.....	\$25,000	\$15,000	\$ 5,000	\$45,000
Loss on realization.....	1,000	1,000	1,000	3,000
Capitals after realization.....	<u>\$24,000</u>	<u>\$14,000</u>	<u>\$ 4,000</u>	<u>\$42,000</u>
Loans.....		3,000	7,000	10,000
Total capitals and loans.....	<u>\$24,000</u>	<u>\$17,000</u>	<u>\$11,000</u>	<u>\$52,000</u>
Cash for distribution.....				10,000
Possible loss—in P & L ratio.....	\$14,000	\$14,000	\$14,000	<u>\$42,000</u>
Capital and loan smaller than possible loss.....			11,000	
Additional possible loss to <i>A</i> and <i>B</i> ...			<u>\$ 3,000</u>	
<i>A</i> — $\frac{1}{2}$ of \$3,000.00.....	1,500			
<i>B</i> — $\frac{1}{2}$ of 3,000.00.....		1,500		
Total.....	<u>\$15,500</u>	<u>\$15,500</u>		

These working papers show that *C* cannot safely be paid anything, because his loan and capital balances together amount to only \$11,000.00, whereas he is in danger of being charged with a loss of \$14,000.00. *A* and *B* can be paid amounts which will leave each with a capital (or total capital and loan) of \$15,500.00. The cash should be distributed as follows:

	<u>Balances After Charging off Loss</u>	<u>Cash Distributed</u>	<u>Balances After Distribution</u>
<i>A</i> —Capital.....	\$24,000.00	\$ 8,500.00	\$15,500.00
<i>B</i> —Capital.....	14,000.00	—	14,000.00
Loan.....	3,000.00	1,500.00	1,500.00
<i>C</i> —Capital.....	4,000.00	—	4,000.00
Loan.....	7,000.00	—	7,000.00
		<u>\$10,000.00</u>	

Unpaid liabilities.—If payments are made to partners in installments before the creditors are paid, the liquidator runs the risk of finding himself in a position where he cannot pay the creditors in full because of his inability to realize on the assets. He may be able to recover some of the payments made to the partners, and thus pay the creditors; but if he is unable to do this, he will be personally liable to the creditors. To avoid placing himself in such a position, the liquidator should either refuse to make payments to the partners until all creditors have been paid, or he should withhold sufficient cash to provide a fund with which the creditors can be paid in full, and should distribute only the remaining cash to the partners.

CHAPTER 36

VENTURE ACCOUNTS

Importance of venture accounts.—Under modern conditions of trade, venture accounts are of little practical importance. It appears desirable, however, to devote some attention to the subject, because venture problems are occasionally given in the professional examinations.

Nature of ventures.—It is difficult to define a business venture, because ventures may be conducted in so many different ways. In general it may be said that a venture is a more or less speculative undertaking (usually not a part of the regular operations of the business) involving certain specific goods and terminating when these goods are disposed of.

Years ago, before the present methods of foreign trade were developed, a popular form of venture consisted of placing merchandise in charge of the captain of a vessel, to be sold or bartered at his discretion in some foreign port. With foreign trade now on a basis of regularly conducted purchases and sales, this form of venture is no longer common, but the idea that the term venture implies the shipment of merchandise still persists.

This idea is erroneous and places an unwarranted limitation on the term. While it is true that the merchandise which is the subject matter of the venture may be shipped, ventures may be conducted without making a shipment. Thus, the purchase of a piece of real estate in the hope of a sale at an increased value, or a speculation in stock, is a venture although there is no shipment.

Single and joint ventures.—Just as a business may be conducted by an individual or by a partnership, so ventures may be single or joint. If the venture is conducted by one individual or business, it is a single venture, even though the

business conducting the venture is a partnership or a corporation. If two or more individuals or businesses participate in the venture, furnishing capital, services, or merchandise, and sharing the profits or losses, it is a joint venture.

Single ventures.—If a venture is conducted by one individual or business as sole owner, the accounting is usually very simple. An account may be opened with the venture, and charged with the cost of the merchandise and with all expenses, and credited with the proceeds. The balance of the account is the profit or loss. A consignment out is an illustration of a single venture.

Joint ventures.—If two or more individuals or businesses engage in a venture, a partnership relation exists. Each participant may contribute merchandise or money, each may pay expenses, and each will share in the resulting profit or loss. As in any other partnership, profits will be shared in accordance with any agreement; if there is no agreement, they will be shared equally, regardless of relative investments.

Joint venture accounting.—There are two distinct methods of recording the transactions of a joint venture, the method to be chosen depending upon whether the venture is to be of sufficient duration and complexity to warrant keeping a separate set of books for it. These two methods may be described as follows:

- (1) No separate set of books for the venture.

Each participant records all of the venture transactions in his own books.

- (2) A separate set of books for the venture.

All of the venture transactions are recorded in the venture books.

Each participant records in his own books only those transactions to which he is a party.

First method of accounting.—As ventures are usually of short duration, the first method is commonly used. Each participant opens on his own books an account with the joint venture, and an account with each of the other participants. Transactions are recorded in the books of all parties as follows:

- (1) **Merchandise contributions:**
 The party contributing the merchandise debits Joint Venture and credits Purchases, or Merchandise Contributed to Joint Venture, which is later closed to Purchases.
 Each of the other participants debits Joint Venture and credits the participant making the contribution.
- (2) **Cash payments for the venture:**
 The party making the payment, either for merchandise or for expense, debits the Joint Venture account and credits Cash.
 The other participants debit Joint Venture and credit the participant who made the payment.
- (3) **Cash given by one participant to another to be used for joint venture purposes:**
 The participant furnishing the money debits the account with the participant receiving it and credits Cash.
 The participant receiving the money debits Cash and credits the participant providing the money.
 Other participants, not parties to the transaction, debit the participant receiving the money and credit the participant furnishing it.
 When this money is later spent for the venture, entries are made as indicated in (2).
- (4) **Sales for cash:**
 The participant making the sale debits Cash and credits Joint Venture.
 The other participants debit the participant who received the cash and credit Joint Venture.
- (5) **Sales on account:**
 The participant making the sale debits Accounts Receivable—Joint Venture and credits the Joint Venture account.
 The other participants debit the participant making the sale and credit Joint Venture.
- (6) **Loss from bad debts:**
 The participant who made the sale and is carrying the account, debits Joint Venture and credits Accounts Receivable—Joint Venture.

VENTURE ACCOUNTS

The other participants debit Joint Venture and credit the participant carrying the account.

(7) Expenses paid by participants:

If the expenses are paid in cash specifically for the venture, entries are made as in (2).

But the expense may have been part of a total payment charged by the participant to some expense account; in such cases, when the amount applicable to the venture is ascertained:

The participant who paid the expense debits the Joint Venture account and credits his expense account.

The other participants debit the Joint Venture account and credit the participant making the charge.

(8) Salary allowed to managing participant:

The participant receiving the salary debits Joint Venture and credits Salary.

The other participants debit Joint Venture and credit the participant who is allowed the salary.

(9) Commissions allowed to managing participant:

If commissions are allowed on purchases:

The managing participant debits Joint Venture for the cost of the merchandise plus the commission and credits Cash and Commissions Earned.

The other participants debit Joint Venture for cost plus commission and credit the participant making the purchase.

If commissions are allowed on sales:

The managing participant debits Cash (or Accounts Receivable), credits Commissions Earned, and credits Joint Venture for the net amount.

The other participants debit the participant making the sale and credit Joint Venture for the net amount.

(10) Withdrawals of cash:

The participant receiving the money debits Cash and credits the participant sending the money.

The participant sending the money debits the participant receiving it and credits Cash.

The other participants debit the participant receiving the cash and credit the participant sending it.

(11) Withdrawals of merchandise:

The participant receiving merchandise debits Purchases and credits Joint Venture.

The other participants debit the one receiving the merchandise and credit Joint Venture.

(12) Interest:

It is sometimes considered equitable to allow interest on investments from the date of each investment to the date of settlement, and to charge interest on withdrawals from the date of each withdrawal to the date of settlement.

The net credit or debit is computed, and an entry is made on each participant's books as follows:

Debit Joint Venture for total.

Credit Interest Earned for own allowance.

Credit other participants for their allowances.

(13) Distribution of profit:

After the venture has been completed, the balance of the Joint Venture account will be the amount of the profit or loss. Assuming that a profit has been made, each participant will close the Joint Venture account by an entry as follows:

Debit Joint Venture for total profit.

Credit Profit on Joint Venture for own share.

Credit other participants for their shares.

(14) Final settlement:

Each participant has an account with each other participant. To illustrate, assume that the books of three joint venture participants contain the following balances:

	<u>X's Books</u>	<u>Y's Books</u>	<u>Z's Books</u>
Account with X.....		\$1,000 Cr.	\$1,000 Cr.
Account with Y.....	\$1,500 Cr.		1,500 Cr.
Account with Z.....	2,500 Dr.	2,500 Dr.	

X is entitled to receive \$1,000.00 in final

VENTURE ACCOUNTS

settlement of the venture, and *Y* is entitled to receive \$1,500.00; these amounts, totaling \$2,500.00, should be paid to *X* and *Y* by *Z*. When *Z* makes the payments, the following entries should be made:

	<u>X's Books</u>	<u>Y's Books</u>	<u>Z's Books</u>
Debits:	Cash 1,000	X 1,000	X 1,000
	Y 1,500	Cash 1,500	Y 1,500
Credit:	Z 2,500	Z 2,500	Cash 2,500

Illustration.—The following transactions of a joint venture will be used to illustrate the first method of making joint venture entries. (See pages 89 and 90.)

- (1) June 1—*A* ships merchandise to *C*, who is to manage the venture. The merchandise is valued at \$3,000.00.
- (2) “ 1—*A* pays freight on the merchandise, \$20.00.
- (3) “ 1—*A* makes a charge for delivery services of \$10.00. As he uses his own delivery equipment, the \$10.00 is credited to Delivery Expense.
- (4) “ 1—*B* sends *C* \$2,000.00 in cash.
- (5) “ 1—*B* sends *C* a thirty-day draft for \$1,000.00.
- (6) “ 5—*C* buys merchandise at a cost of \$1,500.00, and is allowed a 2% commission for his services.
- (7) “ 11—*C* discounts *B*'s draft, paying \$3.33 discount.
- (8) “ 11—*C* purchases merchandise at a cost of \$4,000.00, and is allowed a 2% commission.
- (9) “ 17—*C* pays expenses, \$75.00.
- (10) “ 24—*C* sells merchandise for \$3,600.00 and is allowed a 2% commission.
- (11) “ 26—*C* sends *A* and *B* each one third of the net proceeds of the sale, keeping one third himself.
- (12) “ 30—*C* sells the balance of the merchandise for \$6,000.00, and is allowed a 2% commission.
- (13) July 1—Interest is to be credited to all participants on credit entries in their accounts, and charged to them on debit entries. Interest is to be computed from date of entry to July 1. [In the case of the draft given by *B* to *C*, *B* is to be credited and *C* is to be charged with interest on the proceeds of the draft (\$996.67) from the date of discount (June 11) to July 1.]
- (14) “ 1—Profits are divided equally.
- (15) “ 1—Settlement is made; *C* sends checks to *A* and *B*.

	<u>A's Books</u>		<u>B's Books</u>		<u>C's Books</u>	
(1) June 1	Joint Venture.	3,000.00	Joint Venture	3,000.00	Joint Venture.	3,000.00
	Purchases.		A.		A.	
	A contributes merchandise.					
(2) June 1	Joint Venture.	20.00	Joint Venture	20.00	Joint Venture.	20.00
	Cash.		A.		A	
	A pays freight.					
(3) June 1	Joint Venture.	10.00	Joint Venture.	10.00	Joint Venture.	10.00
	Delivery Expense.		A.		A	
	A charges for delivery.					
(4) June 1	C.	2,000.00	C.	2,000.00	Cash	2,000.00
	B sends cash to C.		Cash.		B.	
(5) June 1	C.	1,000.00	C.	1,000.00	Bills Receivable.	1,000.00
	B.		Bills Payable.		B	
	B sends 30-day draft to C.					
(6) June 5	Joint Venture.	1,530.00	Joint Venture	1,530.00	Joint Venture.	1,530.00
	C.		C		Cash	1,500.00
	C buys merchandise.				Commissions Earned.	30.00
(7) June 11	B.	3.33	Interest Expense.	3.33	Cash	996.67
	C.		C		Bills Rec. Disc.	3.33
	C discounts B's draft.					1,000.00
(8) June 11	Joint Venture.	4,080.00	Joint Venture	4,080.00	Joint Venture.	4,080.00
	C.		C.		Cash	4,000.00
	Purchases by C.				Commissions Earned.	80.00
(9) June 17	Joint Venture.	75.00	Joint Venture.	75.00	Joint Venture	75.00
	C		C.		Cash	
	Payment of expenses by C.					
(10) June 24	C	3,528.00	C	3,528.00	Cash	3,600.00
	Joint Venture.		Joint Venture.		Joint Venture.	3,528.00
	Sale by C, less commission.				Commissions Earned.	72.00

A's Books

(11) June 26 Cash..... 1,176.00
 B..... 1,176.00
 C..... 2,352.00
 Remittances by C to A
 and B.

(12) June 30 C..... 5,880.00
 Joint Venture..... 5,880.00
 Sale by C, less commission.

(13) July 1 Joint Venture..... 30.46
 Interest Earned.....
 B.....
 C.....
 Credits for net interest.
 See computation, page 91.

(14) July 1 Joint Venture..... 662.54
 Profit on Venture.....
 B.....
 C.....
 To close out profit.
 See Venture account, page
 91.

(15) July 1 Cash..... 2,089.02
 B..... 2,053.86
 C..... 4,142.88

Final settlement payments
 by C to A and B.
 See explanatory personal
 accounts—page 92.

B's Books

A..... 1,176.00
 Cash..... 1,176.00
 C..... 2,352.00

C..... 5,880.00
 Joint Venture..... 5,880.00

Joint Venture 30 46
 A
 Interest Earned
 C

Joint Venture 662.54
 A
 Profit on Venture
 C

A..... 2,089.02
 Cash 2,053.86
 C 4,142.88

C's Books

A..... 1,176.00
 B..... 1,176.00
 Cash..... 2,352.00

Cash..... 6,000.00
 Joint Venture 5,880.00
 Commissions Earned.. 120.00

Joint Venture 30 46
 A 14 17
 B 12 34
 Interest Earned..... 3.95

Joint Venture 662.54
 A 220.85
 B 220.85
 Profit on Venture..... 220.84

A..... 2,089.02
 B 2,053.86
 Cash 4,142.88

Computation of Interest

(Explanatory of entry 13)

A—Credits:							
June	1	Merchandise	\$3,000.00	30 days	\$15.00		
"	1	Freight.....	20.00	30 "	.10		
"	1	Drayage.....	10.00	30 "	.05		\$15.15
Debits:							
June	26	Cash.....	1,176.00	5 "		.98	
							<u>\$14.17</u>
B—Credits:							
June	1	Cash.....	\$2,000.00	30 "	\$10.00		
"	11	Proceeds of draft.....	996.67	20 "	3.32		\$13.32
Debits:							
June	26	Cash.....	1,176.00	5 "		.98	
							<u>\$12.34</u>
C—Credits:							
June	5	Purchase and Commission	\$1,530.00	26 "	\$ 6.63		
"	11	" " "	4,080.00	20 "	13.60		
"	17	Expenses	75.00	14 "	.18		
"	26	Cash to A and B...	2,352.00	5 "	1.96		\$22.37
Debits:							
June	1	Cash from B.....	2,000.00	30 "	\$10.00		
"	11	Proceeds of B's draft ..	996.67	20 "	3.32		
"	24	Sale less commission. . .	3,528.00	7 "	4.12		
"	30	" " "	5,880.00	1 "	.98		18.42
							<u>\$ 3.95</u>

Computation of Net Profit

(Explanatory of entry 14)

After the interest entry (No. 13) is posted, the profit on the joint venture can be ascertained by computing the balance of the Joint Venture account. Following is the account after the profit has been computed, and distributed by entry 14.

Joint Venture Account

(As it will appear on books of A, B, and C)

June	1	Merchandise—A.	3,000.00	June	24	Sale—C.....	3,528.00
"	1	Freight—A.....	20.00	"	30	" ".....	5,880.00
"	1	Delivery—A	10.00				
"	5	Purchase—C	1,530.00				
"	11	" ".....	4,080.00				
"	17	Expenses—C	75.00				
July	1	Interest.....	30.46				
"	1	Profit: A	220.85				
		B	220.85				
		C	220.84				
			<u>662.54</u>				
			<u>9,408.00</u>				<u>9,408.00</u>

VENTURE ACCOUNTS

Participants' Accounts

After posting the entries for the transactions of the venture (1 to 12), for the interest (13), and for the distribution of profit (14), *A*'s account on the books of *B* and *C* will have a credit balance of \$2,089.02, which is the amount he is entitled to receive in settlement.

B's account on the books of *A* and *C* will have a credit balance of \$2,053.86, which is the amount he is entitled to receive in settlement.

C's account on the books of *A* and *B* will have a debit balance of \$4,142.88, which is the amount he must pay to *A* and *B*: \$2,089.02 to *A*, and \$2,053.86 to *B*. After these payments have been made and recorded by entry 15, the accounts will appear as follows:

Account with A(As it will appear on books of *B* and *C*)

June 26	Cash from <i>C</i>	1,176.00	June 1	Merchandise to <i>C</i>	3,000.00
July 1	" " "	2,089.02	" 1	Freight	20.00
			" 1	Drayage	10.00
			July 1	Interest	14.17
			" 1	Profit	220.85
		<u>3,265.02</u>			<u>3,265.02</u>

Account with B(As it will appear on the books of *A* and *C*)

June 11	Discount on draft	3.33	June 1	Cash to <i>C</i>	2,000.00
" 26	Cash from <i>C</i>	1,176.00	" 1	Draft to <i>C</i>	1,000.00
July 1	" " "	2,053.86	July 1	Interest	12.34
			" 1	Profit	220.85
		<u>3,233.19</u>			<u>3,233.19</u>

Account with C(As it will appear on books of *A* and *B*)

June 1	Cash from <i>B</i>	2,000.00	June 5	Purchase and commission	1,530.00
" 1	Draft from <i>B</i>	1,000.00	" 11	Disc. on <i>B</i> 's draft	3.33
" 24	Sale less commission	3,528.00	" 11	Purchase and commission	4,080.00
" 30	Sale less commission	5,880.00	" 17	Expenses paid	75.00
			" 26	Cash to <i>A</i> and <i>B</i>	2,352.00
			July 1	Interest	3.95
			" 1	Profit	220.84
			" 1	Cash to <i>A</i>	2,089.02
			" 1	" " <i>B</i>	2,053.86
		<u>12,408.00</u>			<u>12,408.00</u>

Uncompleted ventures.—If, at the time of closing the books, an account with an uncompleted venture appears on the books, the inventory may be entered in the account, the profit to date estimated, and the proper share taken up. If one participant makes such entries, all should do so in order to keep the Joint Venture accounts in agreement. However, since ventures are usually speculative in nature, it is generally considered hazardous to take up any profit until the completion of the venture. Therefore the conservative procedure is to leave the account unclosed, showing the facts in the balance sheet as follows, probably under the Current Asset caption:

Net Investment in Joint Venture:		
Total Investment.....	\$1,500.00	
Less Investments of Other Participants...	950.00	\$550.00

If the investment in the venture is relatively small in proportion to the total assets shown by the balance sheet, it is not necessary to indicate the amount of the investment of the other participants; in such instances it is sufficient to show the net investment as a single item in the balance sheet in the manner illustrated below:

Investment in Joint Venture.....	\$550.00
----------------------------------	----------

Second method of accounting.—While the method just described is the one usually followed, a separate set of books may be kept for the transactions of the venture.

With a separate set of books, it is not necessary to keep the Joint Venture account on the participants' books in a manner which will show the purchases, sales, and expenses of the venture. The profits will be determined from the books of the venture. Nor is it necessary for each participant to keep an account with each other participant, as the books of the venture will show the interest of each participant. Each participant keeps only a Joint Venture or an Investment in Joint Venture account, charging it with what he puts into the venture and with his share of the profits, and crediting it with what he takes out. He makes no record of the investments, withdrawals, and expenses of the other participants.

The following entries show how the illustrative transactions would be recorded in the books of the three participants and in the separate venture set. The entries are numbered to correspond with the statement of transactions on page 88.

	<u>Venture Books</u>	<u>A's Books</u>	<u>B's Books</u>	<u>C's Books</u>
(1) Purchases.....	3,000.00	Joint Venture .. 3,000.00		
A.....		Purchases.....	3,000.00	
(2) Expense	20.00	Joint Venture...	20.00	
A.....		Cash.....	20.00	
(3) Expense	10.00	Joint Venture...	10.00	
A.....		Expense.....	10.00	
(4) Cash.....	2,000.00		Joint Venture... 2,000.00	
B.....			Cash.....	2,000.00
(5) Bills Receivable. 1,000 00			Joint Venture .. 1,000.00	
B			Bills Payable..	1,000.00
(6) Purchases.....	1,500.00			
Cash.....	1,500.00			
Commissions....	30.00			Joint Venture... 30.00
C.....				Commissions..
(7) Cash.....	996.67		Interest.	3.33
B.....			Joint Venture.	3.33
Bills Rec.	3.33			
Disc.....	1,000.00			
(8) Cash*.....	2,503.33			Joint Venture... 2,503.33
C.....				Cash
Purchases.....	4,000 00			2,503.33
Cash.....	4,000.00			
Commissions....	80.00			Joint Venture... 80.00
C.....				Commissions..
(9) Expense.....	75.00			Joint Venture... 75.00
C.....				Cash.....

* Amount which C must have contributed from his own funds to provide the cash necessary to make the \$4,000.00 purchase.

	<u>Venture Books</u>	<u>A's Books</u>	<u>B's Books</u>	<u>C's Books</u>
(10) Cash	3,600.00			
Commissions	72.00			72.00
Sales				
(11) A	1,176.00	Cash	1,176.00	Cash
B	1,176.00	Joint Venture.	1,176.00	Commissions..
C	1,176.00			
Cash	3,528.00			
(12) Cash	5,880.00			
Commissions	120.00			
Sales				
(13) Profit & Loss	30.46	Joint Venture ..	14.17	Joint Venture ..
A		Interest	14.17	Interest
B				
C				
(14) Profit & Loss	662.54	Joint Venture ..	220.85	Joint Venture ..
A		Profit on J. V.	220.85	Profit on J. V.
B				
C				
(15) A	2,089.02	Cash	2,089.02	Cash
B	2,053.86	Joint Venture.	2,053.86	Joint Venture.
C	1,737.12			
Cash	5,880.00			

The venture accounts which will appear on the various participants' books are illustrated by the following account kept by *A*:

A's Account with Joint Venture

Merchandise..... 3,000.00 Expense..... 20 00 "..... 10 00 Interest..... 14.17 Profit..... 220.85 <hr style="width: 100%;"/> 3,265.02	Cash.. 1,176.00 Cash—Final Settlement... 2,089.02 <hr style="width: 100%;"/> 3,265.02
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The capital accounts which will appear on the venture books are illustrated by the following account with *A*:

Joint Venture's Account with A

Cash..... 1,176.00 Cash—Final Settlement. 2,089.02 <hr style="width: 100%;"/> 3,265.02	Merchandise..... 3,000.00 Expense..... 20.00 "..... 10.00 Interest..... 14 17 Profit..... 220.85 <hr style="width: 100%;"/> 3,265.02
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In a similar way, *B*'s account with the venture would be reciprocal with the venture's account with *B*; and the same would apply to *C*'s accounts.

Attention is again called to the fact that the first method is the one to be used when joint venture accounts are called for and no accounting method is specified.

Interest.—The computation of interest in the preceding illustrations of the two methods of accounting, was based on the assumption that *C*, as manager of the venture, was permitted to merge the venture funds with his own, and was therefore properly chargeable with interest on advances made to him.

CHAPTER 37

INSURANCE

Introduction.—An insurance policy is a contract between an insurance company and the insured, by which the company agrees to pay the insured for a specified damage, loss, or liability, contingent upon the occurrence of some event.

Premiums are usually payable in advance. The rates represent the charge per \$100.00 or \$1,000.00 of insurance carried per year, and are usually computed on a standard basis which is adjusted, by local factors and indorsement clauses, to the requirements of particular cases. Policies, except those for life insurance, generally cover a period of from one to three years; rate advantages are usually obtained by purchasing policies covering a period of more than one year. Cancellation, except in rare instances, may be effected by either party upon notice to the other; a specified time must usually elapse before the cancellation becomes effective. If the policy is cancelled by the company, the premium refundable to the insured will be computed on a pro-rata basis; if the policy is cancelled by the insured, the premium refundable to him will be computed on a "short rate" basis, and will be less than the unexpired portion of the premium.

An accountant should have a knowledge of the types of insurance protection available; he should know whether changes in specific or total asset values will affect the coverage in force; he should understand the proper accounting treatment of accrued and unexpired premiums, rebates, dividends, and surrender and loan values; and he should know what accounts and records are necessary to prove an insured loss and to obtain settlement.

In this chapter we shall give especial consideration to fire, life, and workmen's compensation insurance, which present the principal accounting problems, and shall mention some of the distinguishing features of a few other important types of insurance.

Fire Insurance

General.—The hazard of fire is probably the most serious business risk covered by insurance. Property insurable against fire may be classified as:

Buildings.

Building contents: merchandise, machinery, materials, fixtures, and so forth.

Miscellaneous property: automobiles, boats, property carried in yards, and so forth.

The rates for fire insurance depend upon construction, occupancy, exposure, and protection. Construction means the material used and the number of stories in the building insured, or in the building containing the property insured. Occupancy refers to any special hazards resulting from the nature of the business conducted. Exposure means the distance from other buildings, and any hazard which might arise from the proximity of dangerous buildings. Protection refers to such matters as distance from a fire hydrant, the efficiency of the fire department, the installation of automatic sprinklers, and the employment of watchmen.

The co-insurance clause.—Because losses are often only partial, there is a tendency to insure for only a portion of the value of the property. To combat this tendency, policies may contain a co-insurance clause, in which the insured consents, in consideration of a reduction in the rate, to carry insurance in an amount equal to a stipulated per cent of the value of the property. The following is such a clause:

“In consideration of the premium for which this policy is issued, it is expressly stipulated that, in event of loss, this company shall be liable for no greater proportion thereof than the sum hereby insured bears to 80% of the cash value of the property described herein at the time when such loss shall happen.”

If the insured does not carry insurance in an amount equal to the co-insurance requirements, he is regarded as being himself a co-insurer with the insurance company; that is,

he carries a portion of the risk. For example, if, under an 80% co-insurance policy, the insured carries insurance equal to only 70% of the value of the property, he is a co-insurer for 10%. Any loss will be borne seven eighths by the company and one eighth by the insured; however, the company will not be liable for more than the face of the policy. If the policy is 80% of the sound value of the property, the company will be liable for all losses up to the face of the policy.

The operation of this clause is illustrated below.

First illustration:

Value of property.....	\$10,000 00
Policy—80%..	8,000.00
The company is liable for all losses up to \$8,000.00.	

Second illustration:

Value of property.....	\$10,000 00
Policy—more than 80%.	8,500.00
The company is liable for all losses up to \$8,500.00.	

Third illustration:

Value of property.....	\$10,000.00
Policy—70%.....	7,000.00
Loss.....	4,000.00
The insured is a co-insurer for $\frac{1}{8}$ of all losses, and the company's liability is $\frac{7}{8}$ of \$4,000.00, or \$3,500.00.	

Fourth illustration:

Value of property.....	\$10,000.00
Policy—65%.....	6,500.00
Loss.....	4,000.00
The insured is a co-insurer for $\frac{1}{60}$ of all losses, and the company's liability is $\frac{59}{60}$ of \$4,000.00, or \$3,250.00.	

Fifth illustration:

Value of property—total loss.....	\$10,000.00
Policy—65%.....	6,500.00
$\frac{6}{60}$ of \$10,000.00 is \$8,125.00, but the policy is for only \$6,500.00; hence the company's liability is \$6,500.00.	

From these illustrations the following general rule may be derived. To determine the insurance company's liability under a policy with the 80% co-insurance clause: When the

policy is less than 80% of the sound value of the property, multiply the loss by a fraction, the numerator of which is the face of the policy and the denominator of which is 80% of the sound value of the property. The product is the liability of the company, except that the liability cannot be more than the face of the policy.

If the insured amount is 80% or more of the sound value of the property, the co-insurance clause does not affect the settlement.

When the policy contains a co-insurance clause, it is important to watch changing values of the insured property, caused either by additional purchases or by increases in market value. To illustrate, assume that property was purchased at a cost of \$5,000.00 and insured for \$4,000.00 under a policy containing an 80% co-insurance clause. Later, when the property had a sound value of \$8,000.00, it was destroyed, with a loss of \$4,000.00. Settlement would be made as follows:

Sound value.....	\$8,000.00
80% thereof.....	6,400.00
Company's liability: $4\frac{3}{4}$ of \$4,000.00, or	\$2,500.00.

Although of particular importance in fire insurance, co-insurance clauses may be included in policies for other types of insurance. An 80% co-insurance rate was used in the preceding illustrations because it is the usual rate in fire insurance policies; the co-insurance rates in other types of insurance policies vary greatly.

Contribution clause.—If property is insured with several companies, each company whose policy contains a contribution clause assumes a liability for only a pro-rata portion of the loss; this portion is computed by multiplying the loss by a fraction, the numerator of which is the face of the policy, and the denominator of which is:

- (1) The face of all policies, if the company's policy carries no co-insurance clause (see *Company A*, below) or if the insurance carried meets the requirements of the policy (see *Company B*, below).
- (2) The insurance required under the co-insurance clause, if the company's policy contains such a clause and

its requirements have not been met (see Company C, below).

To illustrate, assume that property having a sound value of \$100,000.00 is insured under the policies described below, and that a loss of \$75,000.00 is incurred. The amount collectible from each company is computed as follows:

Company	Co-Insurance Clause	INSURANCE			Loss	Amount Collectible
		Required by C.-I. Clause	Carried	Fraction		
A	None	—	\$40,000.00	$\frac{4}{100}$	\$75,000.00	\$37,500.00
B	75 %	\$75,000.00	20,000.00	$\frac{2}{100}$	75,000.00	18,750.00
C	90 %	90,000.00	20,000.00	$\frac{2}{100}$	75,000.00	16,666.67
Total.....			<u>\$80,000.00</u>			<u>\$72,916.67</u>

Floater policies.—Under a floater policy, the insured property may be moved from one place to another for processing, storing, or other purposes. The property is insured, regardless of its location, within specified geographical limits, and with limitations upon the amount payable on a loss at any one location. Under this type of policy, inventory records showing the value of property at various locations are desirable for the purpose of proving losses.

Losses.—Settlements for losses are usually based on the sound value of the property at the date of the loss; that is, cost or market value new, as of that date, less depreciation. Salvage is the sound value of property saved. The amount of the loss is the sound value of the property minus the salvage.

In the event of a loss, the insured should notify the company at once, and should file a formal proof of loss, usually within sixty days and usually on a form provided by the company, showing, among other things, the cash value of the property at the time of the loss and the amount of the recovery claimed.

If the insured and the company cannot agree on the amount of the loss, each may appoint a competent, disinterested appraiser; the appraisers then appoint an umpire; if the appraisers fail to agree upon a settlement, the umpire's decision is final.

Fire loss account.—When a fire occurs, a Fire Loss account should be immediately set up. It should be charged with:

The carrying value of the fixed assets destroyed or damaged.

The estimated value of the inventories.

The unexpired insurance.

It should be credited with:

The value of the salvage.

The settlement received from the insurance company.

The balance of the account should be closed to Surplus, and not to Profit and Loss, as it does not represent an element of normal operations.

Carrying value of assets.—If the fire occurs some time after the closing of the books, there will be accrued depreciation to record. This should be put on the books in the customary manner, by debiting depreciation accounts and crediting depreciation reserve accounts.

If all of the fixed assets are destroyed, the entire offsetting depreciation reserve should be closed to each fixed asset account, and the resulting balances of the fixed asset accounts should be closed to Fire Loss. If only a partial loss is sustained, the fixed asset accounts should be relieved of the cost of the property destroyed, and the depreciation reserves should be relieved of the depreciation provided on such property.

If the salvage is to be sold, no entries for salvage should be made until sales are effected; the Fire Loss account should be held open until that time in order to show the final surplus adjustment resulting from the fire. If the salvage is to be put back into use, the fixed asset accounts should be debited and Fire Loss credited with the agreed value.

Estimated values of inventories.—The method of estimating the value of the merchandise inventories on hand at the date of the fire, will depend upon the accounting records kept. If perpetual inventories are maintained, they usually furnish the best possible evidence of quantities. If there are no perpetual inventories, the gross profit method may be

used. To illustrate, assuming an inventory of \$30,000.00 at the last closing, purchases of \$60,000.00 between the date of closing and the date of the fire, sales of \$75,000.00, and an estimated gross profit of $33\frac{1}{3}\%$, the inventory at the date of the fire might be estimated as follows:

Inventory, at date of last closing.....	\$30,000.00	
Add purchases.....	60,000.00	
Total.....	\$90,000.00	
Less estimated cost of sales:		
Sales.....	\$75,000.00	
Less gross profit— $33\frac{1}{3}\%$	25,000.00	50,000.00
Estimated inventory at date of fire.....		<u>\$40,000.00</u>

The value thus ascertained may be subject to scaling down by the adjuster for depreciation in the value of goods which were shopworn, damaged prior to the fire, or out of style.

In this connection it is important to note the effect on the estimated inventory valuation if the inventory at the date of the last closing was written down to a market value below cost, or was marked down because of depreciation or obsolescence. Assume, for instance, that the inventory at the date of the last closing cost \$30,000.00 but was written down to \$25,000.00. Using all other figures in the preceding illustration, the inventory value at the date of the fire would be reduced \$5,000.00, as shown below:

Inventory, at date of last closing.....	\$25,000.00	
Add purchases.....	60,000.00	
Total.....	\$85,000.00	
Less estimated cost of sales:		
Sales.....	\$75,000.00	
Less gross profit— $33\frac{1}{3}\%$	25,000.00	50,000.00
Estimated inventory at date of fire.....		<u>\$35,000.00</u>

It is apparent that the inventory value at the date of the fire is reduced \$5,000.00. This is the amount of the conservative provision for decreases in market value or for other losses applicable to the inventory which was on hand at the date of the last closing. But all of these goods, or a large portion of them, may have been sold, so that the inventory at the date of the fire should be stated at \$40,000.00 instead of at \$35,000.00.

It would certainly be unfortunate if the fact that a mer-

chant deducted \$5,000.00 from his inventory on January 1, in order to state his profits conservatively, caused him to suffer an unwarranted loss in the estimated value of an inventory on hand at, say, the following September 1. To avoid such a loss, it is advisable to preserve inventory sheets showing both the cost and market, or depreciated, values.

The question remains concerning the entries to be made for the inventory. If desired, the books may be closed, but this would be an unusual procedure; after the inventories are set up in the usual manner, as an incident to such a closing, the value of the destroyed inventories may be transferred from the inventory accounts to the Fire Loss account. In making the closing entries and the entries transferring inventory values to the Fire Loss account, the accountant should use estimated values and not those allowed by the adjuster. If the adjuster's values were used, any extraneous loss resulting from his scaling down of values, or any extraneous profit resulting from an excess of market value at the date of the fire over cost, would be improperly merged in the operating accounts instead of being clearly shown as an extraneous item in the Fire Loss account, where it belongs.

If it is not desired to close the books at the date of the fire, the debits to Fire Loss for inventories destroyed may be offset by credits to Raw Materials Burned, Goods in Process Burned, and Finished Goods Burned. These accounts will remain open until the next closing of the books.

Unexpired insurance.—All insurance premiums expired between the date of the last closing and the date of the fire should be charged to the Insurance expense account. If the loss is so great as to exhaust the policy and cause its cancellation, all insurance unexpired at the date of the fire should be charged to the Fire Loss account. If the loss is only partial, the payment will be indorsed on the policy and the remainder of the policy will continue in force. In such cases, the Fire Loss account should be charged with such a proportion of the unexpired insurance as the indorsement bears to the face of the policy.

To illustrate, assume that, on January 1, insurance policies of \$40,000.00 were carried and that the unexpired

insurance was \$600.00. All policies were to expire on the following December 31. A fire occurred on September 1, and \$30,000.00 was received from the insurance company. The insurance premium entries should be:

Insurance.	400.00	
Unexpired Insurance.		400.00
To charge operations with insurance premiums expired between January 1 and September 1.		
Fire Loss.....	150.00	
Unexpired Insurance.....		150.00
To charge Fire Loss with three fourths of the \$200.00 insurance premiums unexpired on September 1, the insurance company having paid \$30,000.00 on policies of \$40,000.00.		

Desirable records.—To facilitate the preparation of a proof of loss, the following books and records are desirable:

- (1) A plant ledger, with a separate account for each item of fixed property, showing cost and depreciation taken.
- (2) Vouchers and supporting bills which may be submitted to the adjuster, if demanded, in proof of cost.
- (3) A perpetual inventory, or inventory sheets showing both cost and marked-down values.
- (4) A record showing exactly what property is insured under each policy.

An appraisal of fixed assets is extremely important from an insurance standpoint, even though it is not recorded on the books. It is of service in determining insurance requirements, under co-insurance clauses and otherwise, and in effecting settlements in case of loss.

Life Insurance

Business uses.—The following are some of the important reasons why a business may insure the lives of its owners or employees:

- (1) To provide funds for the purchase of the shares of a deceased stockholder in a close corporation, and thus keep the stock under the control of interested parties.

- (2) To provide funds for the payment of the capital interest of a deceased partner, without placing an undue strain on the working capital.
- (3) To compensate for the loss which might result from the death of an important member of the organization.

Beneficiaries.—If the insured or his estate is the beneficiary, the premiums are virtually additional salary, and should be so recorded. Such insurance, however, is not customary.

Usually the business is named as the beneficiary. To be so named, the business must have an insurable interest in the life of the person insured. An insurable interest exists if the business has a reasonable ground for expecting some benefit or advantage from the continued life of the insured.

Premiums, dividends, and cash and loan values.—Life insurance premiums are payable in advance, usually at annual intervals, but sometimes semiannually, quarterly, or monthly. In the illustrations in this chapter, it is assumed that premiums are payable annually.

Dividends are distributions, to policy holders, of a portion of the earned surplus of mutual insurance companies. Various options may be exercised with respect to the use of dividends, but in business insurance they are probably applied most frequently as a deduction from the premiums payable. Dividends often are not payable on a policy before the end of the second year of its life.

The cash surrender value is the amount which the insurance company will pay to the insured upon cancellation of the policy; a policy usually has no cash surrender value until the end of the third policy year, although the policies of some companies provide for a surrender value at the end of the second year.

The loan value is the amount which the insurance company will loan on a policy maintained in force. The loan value at any date is equal to the cash surrender value at the end of the policy year, minus discount thereon from the loan date to the end of the policy year. If a policy has a cash surrender value at the end of the third year,

it has a loan value at the beginning of the third year, after the payment of the third year's premium. The following table shows one company's cash surrender values on a \$50,000.00 straight life policy taken at the age of thirty-five; values are given here for only the earlier years of the policy. The loan values at the beginning of each year were computed by discounting the end-of-year cash values at 6%; that is, the cash values which will be available one year after making the premium payment were divided by 1.06 to determine the loan values at the date of paying the premium.

Year	<u>Cash Surrender Value at End of Year</u>	<u>Loan Value at Beginning of Year</u>
1	—	—
2.....	—	—
3.....	\$1,590.50	\$1,500.47
4.....	2,151.00	2,029.25
5.....	2,908.00	2,743.40
6.....	3,647.00	3,440.57

The premium less any dividend applied in reduction thereof is the net amount payable to the insurance company. The net premium less the increase in the cash or loan value during the year is the net expense to the insured for the year.

Accounting for net premiums and policy values.—Premiums paid should be charged to Life Insurance Expense. Dividends received should be credited to the same account. If the dividends are applied in reduction of premiums, the net premium should be charged to Life Insurance Expense.

The cash or loan value of the policy should be set up as an asset, and the annual increase therein should be credited to Life Insurance Expense. When the initial value is placed on the books during the third year of the policy's life, two thirds of the value should be regarded as applicable to the first two years of the policy's life, and a Surplus adjustment should be made with respect thereto; the other one third should be regarded as a reduction of the current year's insurance expense. Term policies have no cash surrender value.

Some companies take up the increase in cash surrender value at the end of the policy year; other companies take up the increase in loan value at the beginning of the policy year. Both methods are illustrated below. Dividends are

ignored in the illustrations. In the first two illustrations it is assumed that the policy anniversary date coincides with the close of the accounting period.

Cash values taken up at end of year.—This illustration is based on a straight life policy of \$50,000.00, taken at the age of thirty-five, with an annual premium of \$1,405.50. The cash values are those shown in the foregoing table. Entries for the first four years are given below.

First and second years:

Life Insurance Expense.....	1,405.50	
Cash.....		1,405.50
Entry at beginning of year for payment of premium.		
Profit and Loss.....	1,405.50	
Life Insurance Expense.....		1,405.50
Entry at end of year to charge off expense.		

Third year:

Life Insurance Expense.....	1,405.50	
Cash.....		1,405.50
Entry at beginning of year for payment of premium.		
Cash Surrender Value of Life Insurance... Surplus ($\frac{2}{3}$ of \$1,590.50).....	1,590.50	1,060.33
Life Insurance Expense.....		530.17
Entry to take up cash surrender value at end of year.		
Profit and Loss (\$1,405.50 - \$530.17).....	875.33	
Life Insurance Expense.....		875.33
Entry at end of year to charge off expense.		

Fourth year:

Life Insurance Expense.....	1,405.50	
Cash.....		1,405.50
Entry at beginning of year for payment of premium.		
Cash Surrender Value of Life Insurance... Life Insurance Expense.....	560.50	560.50
Entry at end of year for increase in cash surrender value from \$1,590.50 to \$2,151.00.		
Profit and Loss.....	845.00	
Life Insurance Expense.....		845.00
Entry at end of year to charge off expense.		

Loan values taken up at beginning of year.—When loan values are taken up at the beginning of the year, precision in terminology might suggest the use of an account with some title such as Loan Value of Life Insurance, instead of Cash Surrender Value of Life Insurance. However, such a distinction is not usually made. Moreover, as will be shown in the final illustration, the account may at times show surrender values as well as loan values.

First and second years:

Life Insurance Expense	1,405.50	
Cash		1,405.50
Entry at beginning of year for payment of premium.		
Profit and Loss	1,405.50	
Life Insurance Expense		1,405.50
Entry at end of year to charge off expense.		

Third year:

Life Insurance Expense	1,405.50	
Cash		1,405.50
Entry at beginning of year for payment of premium.		
Cash Surrender Value of Life Insurance	1,500.47	
Surplus ($\frac{2}{3}$ of \$1,500.47)		1,000.31
Life Insurance Expense		500.16
Entry at beginning of year to take up loan value.		
Profit and Loss	905.34	
Life Insurance Expense		905.34
Entry at end of year to charge off expense.		

Fourth year:

Life Insurance Expense	1,405.50	
Cash		1,405.50
Entry at beginning of year for payment of premium.		
Cash Surrender Value of Life Insurance	528.78	
Life Insurance Expense		528.78
Entry at beginning of year for increase in loan value from \$1,500.47 to \$2,029.25.		
Profit and Loss	876.72	
Life Insurance Expense		876.72
Entry at end of year to charge off expense.		

Advantage of taking up loan values.—The author favors taking up loan values at the beginning of the policy year, instead of cash values at the end of the policy year, for the following reasons:

- (1) The asset value of the policy is more accurately reflected. It is particularly desirable to have the loan value of the policy reflected on the books and in the balance sheet if loans are made to the full amount of the available loan value. The following summary shows this fact clearly:

Beginning of Policy Year	Loans	ASSET VALUES	
		Loan Value	Cash Value
3	\$1,500.47	\$1,500.47	—
4	2,029.25	2,029.25	\$1,590.50

Assume that the full amounts of available loans are taken, as shown in the first column; if the loan values are taken up at the beginning of each policy year, the accounts and the balance sheet will show that the asset values of the policy are equal to the loans. But if cash values are taken up at the end of each year, the books and the balance sheet will misrepresent the condition by indicating that the asset values of the policy are less than the liabilities on policy loans.

- (2) A truer statement of the annual expense is obtained, particularly if the end of the policy year does not coincide with the end of the accounting period. The insurance expense for any year is the net premium paid, minus the increase in asset value during the year. However, if the books are closed during the policy year, after the premium payment has been recorded but before the increase in asset value resulting therefrom has been recorded, the true net expense for the year will not be shown.

Closing the books during the policy year.—Using the same figures as in the preceding illustration, assume that loan values are taken up at the beginning of the policy year, that September 30 is the end of the policy year, and that the books are closed on December 31. The entries are

shown by the following statement; credits are indicated by asterisks.

	Insurance Expense	Cash Surrender Value	Profit and Loss	Surplus
First policy year:				
Oct. 1—Premium paid.....	\$1,405 50			
Dec. 31—Expense (Note 1)...	<u>351.38*</u>		\$ 351.38	
Deferred.....	\$1,054.12			
Second policy year:				
Oct. 1—Premium paid.....	1,405.50			
Dec. 31—Expense (Note 2)...	<u>1,405 50*</u>		\$1,405 50	
Deferred.....	\$1,054.12			
Third policy year:				
Oct. 1—Premium paid.....	1,405.50			
Loan value (Note 3)	875 27*	\$1,500.47		\$625.20*
Dec. 31—Expense (Note 4)...	<u>905 34*</u>		\$ 905.34	
Deferred (Note 4)..	\$ 679.01			
Fourth policy year:				
Oct. 1—Premium paid.....	1,405 50			
Loan value increase.	528.78*	528.78		
Total loan value....		<u>\$2,029.25</u>		
Dec. 31—Expense (Note 5)...	<u>898.19*</u>		\$ 898.19	
Deferred.....	\$ 657.54			

Notes

Note 1.—The payment of premium on October 1 covers the expense for the next twelve months; three months' proportion (one fourth) is charged to Profit and Loss, and nine months' proportion (three fourths) is deferred.

Note 2.—Profit and Loss should now be charged with a full year's premium; however, there is again a prepayment of premium for nine months, which should be deferred.

Note 3.—The credit for the loan value is apportioned between Surplus and Life Insurance Expense on the following basis: The loan value was created by the payment of premiums for three years (thirty-six months). The expense for one year and three months (fifteen months) has already been charged to Profit and Loss, and thence to Surplus; the charge for the premiums applicable to the remaining year and nine months (twenty-one months) remains in the Life Insurance Expense account. Then:

$1\frac{5}{8}$ of \$1,500.47 = \$625.20, credited to Surplus.

$2\frac{1}{8}$ of 1,500.47 = 875.27, credited to Life Insurance Expense.

Note 4.—The apportionment between expired and deferred expense at the end of the third year is determined as follows:

The balance in the Insurance Expense account represents the net cost of insurance for 21 months, as follows:

For 9 months—deferred at beginning	\$1,054.12
For 12 months—charged during the year	1,405.50
Total	<u>\$2,459.62</u>
Less reduction for loan value, applicable ratably to the premiums for 21 months	875.27
Net cost for 21 months	<u>\$1,584.35</u>
Cost for 12 months ($1\frac{1}{2}$ months) written off	905.34
Cost for 9 months ($\frac{1}{2}$ month) deferred	<u>\$ 679.01</u>

Note 5.—The amount charged off on December 31 of the fourth policy year is determined as follows:

Amount deferred on preceding January 1, representing the cost for the first 9 months of the calendar year	\$679.01
Cost for the last 3 months of the calendar year:	
Premium paid October 1, for next 12 months	\$1,405.50
Increase in loan value resulting from this payment	528.78
Net cost for 12 months	<u>\$ 876.72</u>
Portion applicable to first 3 months of policy year = $\frac{1}{4}$ of \$876.72	219.18
Total expense for the calendar year	<u>\$898.19</u>
The amount deferred is $\frac{3}{4}$ of \$876.72, or \$657.54.	

The expense for subsequent years should be computed in the same manner as for the fourth year. The peculiar complication in the third year results from the fact that the loan value was put on the books during that year.

Amortization of discount.—If the books are closed monthly or at a date other than the end of the policy year, strict accuracy should probably require the amortization of the discount which was deducted from end-of-year cash values to determine beginning-of-year loan values. In the preceding illustration, these discount deductions were:

	Third Year	Fourth Year
Cash surrender value—end of year	\$1,590.50	\$2,151.00
Loan value—beginning of year	1,500.47	2,029.25
Discount	<u>\$ 90.03</u>	<u>\$ 121.75</u>

The loan value on each December 31 will be greater than the loan value on the preceding October 1, because of the smaller discount which would be deducted. The computation of the loan value at any date by amortization of the discount for the expired portion of the policy year, is illustrated as follows:

Loan value, beginning of third policy year.....	\$1,500.47
Loan value on following December 31:	
Add discount for three months— $\frac{1}{4}$ of \$90.03.....	22.51
Total.....	<u>\$1,522.98</u>

The effect of such discount adjustments upon the loan values and insurance expense is shown by the following summary; variations from the preceding illustration are mentioned in the notes.

	Insurance Expense	Cash Surrender Value	Profit and Loss	Surplus
First policy year:				
Oct. 1—Premium paid.....	\$1,405.50			
Dec. 31—Expense.....	351.38*		\$ 351.38	
Deferred.....	<u>\$1,054.12</u>			
Second policy year:				
Oct. 1—Premium paid.....	1,405.50			
Dec. 31—Expense.....	1,405.50*		<u>\$1,405.50</u>	
Deferred.....	<u>\$1,054.12</u>			
Third policy year:				
Oct. 1—Premium paid.....	1,405.50			
Loan value.....	875.27*	\$1,500.47		\$625.20*
Dec. 31—Discount adjustment (Note 1).....	22.51*	22.51		
Total loan value....		<u>\$1,522.98</u>		
Expense (Note 2)...	882.83*		<u>\$ 882.83</u>	
Deferred.....	<u>\$ 679.01</u>			
Fourth policy year:				
Oct. 1—Discount adjustment (Note 3).....	67.52*	67.52		
Premium paid.....	1,405.50			
Loan value increase (Note 4).....	438.75*	438.75		
Total loan value....		<u>\$2,029.25</u>		
Dec. 31—Discount adjustment (Note 5).....	30.44*	30.44		
Total loan value....		<u>\$2,059.69</u>		
Expense (Note 6)...	822.74*		<u>\$ 822.74</u>	
Deferred.....	<u>\$ 725.06</u>			

Notes

Note 1.—The discount adjustment on December 31 of the third policy year is one fourth of the total discount (\$90.03) deducted on October 1 from the end-of-year cash value to determine the beginning-of-year loan value.

Note 2.—The charge to Profit and Loss on December 31 of the third policy year is the same as that in the preceding illustration

(\$905.34) minus the discount amortization (\$22.51).

Note 3.—The discount adjustment (\$67.52) on October 1 (end of the third policy year) is the total discount for the year (\$90.03) minus the discount previously amortized (\$22.51).

Note 4.—The increase in loan value (\$438.75) is the same as that in the preceding illustration (\$528.78) minus the two amortizations of the discount totaling \$90.03.

Note 5.—The discount amortization (\$30.44) on December 31 of the fourth policy year is one fourth of the total discount (\$121.75) for that year.

Note 6.—The amount charged to Profit and Loss on December 31 of the fourth policy year was computed as follows:

Amount deferred on preceding January 1, representing cost for the first 9 months of the calendar year.....	\$679.01
Less amortization of discount on October 1, applicable thereto. . .	<u>67.52</u>
Net cost for first 9 months of calendar year.	\$611.49
Cost for the last 3 months of the calendar year:	
Premium paid October 1, for 12 months.	\$1,405.50
Immediate increase in loan value resulting therefrom. . .	<u>438.75</u>
Remainder—applicable to 12 months.	\$ 966.75
Portion applicable to 9 months after December 31—	
$\frac{1}{2}$ of \$966.75—deferred.	<u>725.06</u>
Remainder applicable to first 3 months.	\$ 241.69
Less discount amortization for 3 months.	<u>30.44</u>
Net cost for 3 months.	211.25
Cost for 12 months.	<u>\$822.74</u>

Effect of dividends.—No consideration has been given to dividends in the preceding illustrations. If the dividends are applied in reduction of premiums, they simply reduce the charges to be made to the Life Insurance Expense account for premium payments. If they are left with the insurance company for the purpose of increasing the insurance, they produce increases in the cash surrender and loan values. Consequently they do not affect the principles and methods discussed on the preceding pages; they merely affect the amounts of premiums or asset values.

Balance sheet values.—The balance sheet should show the deferred premium and the cash or loan value of the insurance. Referring to the preceding illustration, the balance sheet on December 31 of the fourth policy year

should show deferred premiums of \$725.06, and the loan value of \$2,059.69.

The deferred premiums should be shown under the Deferred Charge caption, as a separate item or combined with unexpired premiums on other types of insurance. There is some difference of opinion concerning where the cash or loan value should be shown. It is often contended that the cash or loan value should be shown under the Current Asset caption because it is a source of immediately available funds. On the other hand, business life insurance is not customarily carried primarily for the purpose of providing available funds through surrender values. From the standpoint of theoretical definitions, the cash or loan value is a current asset if current assets are defined as cash and other assets which may be converted into cash without interfering with the operations of the business; it is not a current asset if current assets are defined as cash and other assets which will normally be converted into cash in the near future through the regular operations of the business. Bankers probably look with some disfavor upon the classification of cash and loan values as current assets, and prefer to see them classified under captions of Investments or Other Assets. A loan may be deducted from the policy value on the asset side; if a loan is shown as a current liability, the policy value should be shown as a current asset.

Settlements.—The collection of a policy by a corporation will be recorded by crediting Surplus with the entire amount received, if no Cash Surrender Value account appears on the books. If a Cash Surrender Value account has been set up, this account should be credited with a sufficient amount to close it, and the balance should be credited to Surplus.

The entries to be made on the books of a partnership to record the collection of a policy on the life of a partner will depend upon whether the partnership is the beneficiary or only the surviving partners are beneficiaries. If the partnership is the beneficiary, the credit will be divided among the Capital accounts (including the account of the deceased partner) in the profit and loss ratio. If only the surviving partners are beneficiaries, they alone will share in the proceeds and their accounts will be credited in their profit and loss ratio.

Workmen's Compensation and Employers' Liability Insurance

Nature of risk.—Under the common law, employees had great difficulty in recovering from employers for accidents suffered in the course of their employment, but most of the states now have workmen's compensation laws which provide that, for various specific accidents sustained during employment, the employee or his family shall be entitled to receive from his employer a certain fixed sum and/or a percentage of the wages which he would have earned during the period of disability. There is also a tendency to include occupational diseases among the hazards for which the employee shall be compensated. A specific statement of risks and compensations cannot be made, because of the diversity of laws.

Under workmen's compensation insurance, the insurance company assumes the employer's entire liability arising from the workmen's compensation law of the state. Employers' liability insurance gives the employer coverage against common-law suits brought by employees to obtain damages for personal injuries. The two related risks are usually covered by the same policy.

Premiums.—The premium is based upon the amount of the pay roll during the policy period. The previous accident experience of the insured and the safety measures and devices used in his plant are factors affecting the rates to be charged. All of the classes of employees of the insured may be covered by one policy; the rate per \$100.00 of pay roll will be determined for each class separately on the basis of the hazard incident to the nature of the work.

At the beginning of the policy period, an advance premium is paid on the basis of the estimated pay roll. The actual pay roll is determined by an audit made by representatives of the insurance company, and the actual premium thereby determined. If the policy provides for an annual pay roll audit, the advance premium will cover the estimated pay roll for the year; at the end of the year, the insured will pay an additional premium or receive a refund, depending upon whether the advance premium was less or more than the actual premium. If the policy is for a year, but if the audit is made more frequently (say quarterly), the advance pre-

mium will cover the estimated pay roll for one quarter; at the end of the first, second, and third quarters, a payment will be made for the actual premium for the expired quarter; at the end of the fourth quarter, an additional premium payment or refund will be made, based on the difference between the original advance premium and the actual premium for the fourth quarter. The policy usually provides that a certain minimum portion of the advance premium shall not be refundable to the insured.

Since the rate applicable to each class of employees and the total estimated pay roll therefor are stated in the policy, the pay roll records must be kept separately for each class or in such a manner that a summary may be prepared by classifications. Computations of earned premiums are made separately for each class.

Accounting.—The advance premium should be charged to Prepaid Workmen's Compensation Insurance, and this account should be written off to Workmen's Compensation Insurance expense accounts by periodical entries based on the actual pay rolls. To illustrate the procedure, assume that the non-refundable advance premium is \$175.00, and that the total advance premium is \$206.80, computed thus:

Classification	Estimated Payroll for the Year	Rate per \$100.00	Advance Premium
Factory.....	\$20,000.00	\$.80	\$160.00
Shipping.....	4,000.00	.42	16.80
Office.....	10,000.00	.06	6.00
Salesmen.....	15,000.00	.16	24.00
Total.....			<u>\$206.80</u>

The entry for the advance premium payment would be:

Prepaid Workmen's Compensation Insurance.....	206.80
Cash.....	206.80

A summary may be kept to show the earned premium based on the pay roll for each pay roll period, as follows:

Classification	Rate	JULY		AUGUST	
		Pay Roll	Premium	Pay Roll	Premium
Factory.....	.80	\$2,000.00	\$16.00	\$1,960.00	\$15.68
Shipping.....	.42	350.00	1.47	365.00	1.53
Office.....	.06	900.00	.54	1,015.00	.61
Salesmen.....	.16	1,000.00	1.60	1,100.00	1.76
Total.....		<u>\$4,250.00</u>	<u>\$19.61</u>	<u>\$4,440.00</u>	<u>\$19.58</u>

The entry for the premium earned in July might be:

Workmen's Compensation Insurance.....	19.61	
Prepaid Workmen's Compensation Insurance.		19.61

Or the charge might be classified, as follows:

Workmen's Compensation Insurance—Factory....	16.00	
Workmen's Compensation Insurance—Shipping. . .	1.47	
Workmen's Compensation Insurance—Office... . .	.54	
Workmen's Compensation Insurance—Salesmen... .	1.60	
Prepaid Workmen's Compensation Insurance.		19.61

To illustrate the final premium settlement, let us assume that the total premiums payable, based on actual pay rolls for the year, were \$221.30. The Prepaid Workmen's Compensation Insurance account would have been charged with \$206.80 (the prepaid premium) and credited with \$221.30 (the premium based on actual pay rolls) and would therefore have a credit balance of \$14.50, representing the liability for additional premium. If the premiums based on actual pay rolls were \$195.00, the Prepaid Workmen's Compensation Insurance account would have a debit balance of \$11.80, representing the refund receivable from the insurance company. If the actual premiums were only \$160.00, the account would have a debit balance of \$46.80, but the recoverable refund would be only \$31.80, the \$206.80 advance premium minus the \$175.00 minimum premium.

Miscellaneous Types of Insurance

Use and occupancy.—This type of insurance indemnifies the insured for loss of net profits during the period of plant shutdown, for fixed charges which continue during that period, for extraordinary expenses incurred to hasten the replacement of machinery, for extra compensation for overtime, for extra cost of having product manufactured elsewhere while the plant is inoperative, and for other similar costs.

The forms of use and occupancy insurance available are based on the nature of the earning power of the insured; for example:

Straight per diem form, which is suitable if the earning power is distributed evenly throughout the year. The recovery per day is limited to $\frac{1}{300}$ of the full amount of the policy.

Fluctuating or seasonal per diem form, which is suitable if periods of fluctuation in operations can be predetermined. The daily limit of recovery is determined by the fluctuating character of the business.

Use and occupancy insurance may be obtained in connection with fire, riot and civil commotion, sprinkler leakage, water damage, boiler explosion, tornado, and other types of insurance.

If one manufacturer is dependent upon another for a continuous and uninterrupted supply of materials or parts, he can obtain contingent use and occupancy insurance against the loss which would be caused by the supplier's inability to furnish goods.

Explosion; riot and civil commotion.—This type of insurance protects the insured against loss or damage due to riot, insurrection, and explosion resulting from the foregoing or other causes, whether originating on the insured's premises or elsewhere. It does not cover damages done at the direction of governmental or civil authorities, explosions coverable by boiler explosion insurance, fires resulting from such explosions, or loss or damage caused by the military or naval forces of foreign enemies.

Sprinkler leakage.—Such policies insure against loss or damage due to sprinkler leakage, but do not cover loss or damage to the sprinkler system itself. Losses of books of account, money, notes, evidences of indebtedness, and patterns are excluded or the underwriter's liability therefor is greatly limited.

Boiler explosion.—The coverage under policies of this type includes loss of, or damage to, property of the insured, or property of others for which the insured is liable, caused directly by the accident; personal injuries caused by the accident; and items of cost for temporary repairs. The coverage does not include explosions caused by fire, or fire resulting from any cause.

Fidelity bonds.—Fidelity bonds, under which a surety company obligates itself to reimburse the insured for losses resulting from the dishonesty of employees, are issued in the

following forms:

Individual bonds, covering one or a few employees.

Position schedule bonds, covering anyone holding any of the positions scheduled.

Name schedule bonds, covering named employees occupying named positions.

The insured must notify the company promptly upon the discovery of a loss, and time limits are placed upon the filing of claims and the filing of suits against the insurer for losses suffered during the policy period.

Plate glass.—This insurance covers loss due to breakage of glass, and usually the cost of lettering and ornamentation on the glass. It does not cover damage caused by fire, by earthquake, or by workmen engaged in construction or repairs.

Marine insurance.—This type of protection is indispensable for all shippers engaged in foreign commerce. Protection may be obtained under:

A special policy, covering one shipment only.

An open policy, covering all shipments made during a specified period, a premium being charged for each shipment.

A blanket policy, which is similar to an open policy, except that an estimated annual premium is payable in advance.

Public liability and property damage.—Such policies protect the insured against losses resulting from liability for injury to another, or against damage to the property of another, due to negligence of the insured or of his employees or agents. Public liability insurance may be written to cover various types of hazard, such as a contractor's liability for injuries to persons passing a building under construction; a building owner's liability for injury to persons riding in an elevator; an automobile owner's liability for injury to others; physicians' and dentists' liability for malpractice; and so forth. Property damage insurance may be obtained by indorsement to public liability policies.

Public liability policies usually provide that the insurance company shall reimburse the insured for the cost of first aid, defend the insured against damage suits, pay all expenses incurred in connection therewith, and satisfy judgments rendered against the insured—all subject to the limits of the policy. A limit is placed upon the amount to be paid to any one person, or to two or more persons as the result of one accident. Damages resulting from liabilities imposed by workmen's compensation laws are excluded.

Profit insurance.—This type of insurance indemnifies for the profit which would have been made from the sale of finished goods destroyed. For instance, ordinary fire insurance will protect the insured to the extent of the actual cash value of the goods destroyed; profit insurance will further protect him to the extent of the profit which could have been made by the sale of the goods.

Under certain circumstances and on payment of an additional premium, a profit insurance clause may be included in other insurance policies, such as fire, riot and civil commotion, sprinkler leakage, and water damage. The reputation of the applicant may be fully investigated before such insurance is written.

Insurance Register

Form and purpose.—A register of insurance policies is desirable for two purposes: first, to show the policies in force, and the amount of each class of coverage; and second, to show the distribution of the insurance premium expense by months or years. Insurance registers are obtainable with various rulings. The following information should be shown:

Policy number.

Date of policy.

Date of expiration.

Name of insurance company.

Nature of coverage.

Amount of insurance.

Total premium.

Distribution of premium expense by periods.

The nature of the coverage and the amount of the insurance may be shown as follows:

<u>Coverage</u>	<u>Insured Amount</u>
Fire—Building.....	\$150,000.00
Fire—Contents.....	60,000.00
Elevator.....	50,000.00
Steam Boiler.....	50,000.00

If coverage for one risk is carried in several policies, it may be desirable to provide columns in the register so that the coverages may be shown as follows:

<u>COVERAGE</u>					
<u>Fire Building</u>	<u>Fire Contents</u>	<u>Elevator</u>	<u>Steam Boiler</u>	<u>Etc.</u>	<u>Etc.</u>
150,000					
	60,000				
		50,000			
			50,000		
90,000					
	35,000				

The columns to be provided for distribution of premium expense by periods will depend upon whether it is desired to show distributions by years or by months. If distribution by years is sufficient, four or five year columns will suffice. If distribution is desired by months, a column must be provided for each month of the year, for the unexpired premiums at the beginning of the year and for the unexpired premiums at the end of the year, thus:

<u>Unexpired</u>	<u>MONTHLY EXPIRATION</u>						<u>Unexpired</u>
<u>Jan. 1</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>	}} <u>Dec.</u>	<u>Dec. 31</u>	

The totals of the monthly expiration columns will show the amounts to be charged monthly to Insurance Expense and credited to Unexpired Insurance. At the end of each year, a new page must be opened, and all policies in force forwarded to it.

CHAPTER 38

THE STATEMENT OF AFFAIRS

Liquidation accounting.—Four chapters are devoted to the statements and accounts of businesses in financial difficulties. This chapter describes a statement showing the estimated payments which can be made to various classes of creditors; Chapter 39 deals with the accounting under a receivership; Chapters 40 and 41 describe the statements which reflect the results of realization and liquidation.

Insolvency.—The words *insolvent* and *bankrupt* are often used synonymously, but they are not synonymous. Two definitions must be given for the word insolvent.

First, the popular meaning: A person who is not able to pay his debts as they mature in the regular order of business, is said to be insolvent. He may have assets greatly in excess of his liabilities, but these assets may be tied up in such a manner that they cannot be realized promptly enough to meet current liabilities. For example, a merchant may have an investment in store property, merchandise, and accounts receivable greatly exceeding, at a fair valuation, the amount of his liabilities, but the merchandise turns slowly; the accounts receivable are good, but long credit terms have been given and the accounts are not due; and the store property is valuable, but it has no ready market. The merchant cannot pay his debts as they mature, and in the popular meaning of the term he is insolvent. Under the National Bankruptcy Act which was in force between 1867 and 1878, insolvency was thus defined as the inability to meet one's debts in the regular course of trade, regardless of the ratio of the liabilities to the assets at a fair value.

Second, the definition of insolvency in the National Bankruptcy Act now in force (the Act of 1898, as subsequently amended): "A person shall be deemed insolvent within the provisions of this Act whenever the aggregate

of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts."

Bankruptcy.—A person may be insolvent without being bankrupt. According to the definition in the National Bankruptcy Act, a "bankrupt shall include a person against whom an involuntary petition or an application to set a composition aside or to revoke a discharge has been filed, or who has filed a voluntary petition, or who has been adjudged a bankrupt."

Bankruptcy may be either voluntary or involuntary. The bankruptcy law provides that any person, except a municipal, railroad, insurance, or banking corporation, or a building and loan association, shall be entitled to the benefits of the Act as a voluntary bankrupt. The law also provides that any natural person, except a wage earner (defined as an individual who works for wages, salary, or hire, at a rate of compensation not exceeding one thousand five hundred dollars per year) or a person engaged chiefly in farming or the tillage of the soil, any unincorporated company, and any moneyed, business, or commercial corporation (except a municipal, railroad, insurance, or banking corporation, or a building and loan association) owing debts to the amount of one thousand dollars or over, may be adjudged an involuntary bankrupt.

The bankruptcy law provides for the appointment of two officers: a referee and a trustee. The referee is appointed by, and is clothed with certain powers of, the court for the purpose of relieving the court of detailed supervision of the activities of the trustee. Several bankruptcy cases may be assigned to one referee. The trustee is appointed by the creditors, or by the court if the creditors fail to make an appointment. The trustee liquidates the bankrupt estate for the benefit of the creditors. The law provides for the appointment of one or three trustees in each case.

Acts of bankruptcy.—Creditors cannot force a person into involuntary bankruptcy unless he has committed one

of the "acts of bankruptcy," which are: "having (1) conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors, or any of them; or (2) transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or (3) suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before a sale or other disposition of any property affected by such preference, vacated or discharged such preference; or (4) suffered, or permitted, while insolvent, any creditor to obtain through legal proceedings any levy, attachment, judgment, or other lien, and not having vacated or discharged the same within thirty days from the date such levy, attachment, judgment, or other lien was obtained; or (5) made a general assignment for the benefit of his creditors; or, while insolvent, a receiver or a trustee has been appointed, or put in charge of his property; or (6) admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."

"A petition may be filed against a person who is insolvent and who has committed an act of bankruptcy within four months after the commission of such act."

Compositions and extensions.—By the supplementary act of March 3, 1933, courts of bankruptcy are given jurisdiction in certain proceedings for the relief of debtors. Such proceedings may result in compositions (pro-rata settlements) with creditors, or in extensions of time for the payment of debts.

Voluntary assignment.—An insolvent debtor may make an assignment of his assets to an assignee, for the benefit of his creditors. It is the duty of the assignee to realize the assets and to make a pro-rata settlement with the creditors. The debtor is not relieved from liability for unpaid balances unless there has been a composition with the creditors. A composition is an arrangement between the debtor and all of his creditors "whereby each creditor agrees to receive, either in cash or in obligations, a certain proportion of the debt due him," and the debtor is thereby released from

liability for the unpaid balances.

A debtor who has made an assignment may be forced into bankruptcy; but it is usually held that no creditor can be a party to a petition in bankruptcy if he has consented to a liquidation by voluntary assignment.

Receivership in equity.—A receiver in equity is an appointee of a court, who acts under the authority of the court in the management of an insolvent business. The receiver usually operates the business long enough to pay off the creditors, whereupon he returns it to its proprietors. The purpose of the receivership may be a reorganization resulting in a change in the stock and bond issues. If the receiver finds it impossible to operate the business successfully, he may, with the consent of the court, proceed to liquidate it.

Creditors' representatives.—Not infrequently, when a business becomes financially embarrassed, operations are continued under the direction of a committee of the creditors.

Statement of affairs.—The statement of affairs is sometimes used to reflect the financial condition of an insolvent business. Both the balance sheet and the statement of affairs are statements of financial condition. The differences between the two statements are indicated below:

- (1) The balance sheet is prepared from the viewpoint of a going concern; the statement of affairs is prepared from the viewpoint of liquidation.
- (2) In the balance sheet, the assets and liabilities are classified on a going-concern basis, as fixed, current, deferred, and so forth; in the statement of affairs, the liabilities are classified as *pro*, fully secured, partially secured, and unsecured, and the assets are classified to indicate those which have been pledged with creditors and those which are free.
- (3) In the balance sheet, the assets are stated at going-concern values; in the statement of affairs, they are stated at both going-concern values and at estimated realizable values.

Illustration.—The statement of affairs on page 128 is based on the following balance sheet and supplementary information:

THE SMITH COMPANY
Balance Sheet—June 30, 1933

Assets	Liabilities
Cash..... \$ 300.00	Accrued Wages..... \$ 250 00
Accounts Receivable.... 9,000.00	Accounts Payable..... 25,000.00
Merchandise..... 18,000 00	Notes Payable..... 4,000 00
Bonds of X Company.... 3,000 00	Mortgage Payable..... 15,000.00
Land and Buildings..... 25,000.00	Capital Stock..... 10,000.00
	Surplus..... 1,050 00
<u>\$55,300.00</u>	<u>\$55,300 00</u>

The accounts receivable have not been pledged with any of the creditors; their value is estimated as follows:

	Gross Value	Estimated Realizable Value
Good... ..	\$4,000.00	\$4,000.00
Doubtful.. ..	3,000 00	1,500.00
Bad..... ..	2,000.00	—

The merchandise is not pledged, and its estimated realizable value is \$13,500.00.

The bonds of X Company, carried at \$3,000.00, are worth \$3,200.00; they have been pledged as security to the notes payable of \$4,000.00, which are therefore only partially secured.

The land and buildings, which are thought to be worth \$18,000.00, serve as security to the \$15,000.00 mortgage, which is therefore fully secured.

In the statement of affairs on page 128, the balance sheet values are shown in the Book Value columns. The Expected to Realize column shows the amounts which the receiver expects to obtain from these assets, and the Expected to Rank column shows the amounts of unsecured liabilities. The treatment of the various assets and liabilities is discussed in the following sections.

Liabilities having priority.—The National Bankruptcy Act provides:

“(a) The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States,

THE SMITH COMPANY
Statement of Affairs—June 30, 1933

Assets	Expected to Realize	Book Value	Liabilities	Expected to Rank
Assets Pledged with Fully Secured Creditors: Land and Buildings: Estimated Value..... \$18,000.00 Less Mortgage Payable—contra 15,000.00 \$ 3,000.00	\$ 250.00 15,000.00	\$ 250.00 15,000.00	Liabilities Having Priority: Accrued Wages—deducted contra	250.00 15,000.00
Assets Pledged with Partially Secured Creditors: Bonds of X Company—deducted contra Estimated value..... \$ 3,200.00	300.00	4,000.00	Fully Secured Liabilities: Mortgage Payable—deducted contra	3,200.00 \$ 800.00
Free Assets: Cash..... Accounts Receivable \$4,000.00 Good..... 3,000.00 Doubtful..... 2,000.00 Bad..... <u>\$9,000.00</u> Merchandise.. .. . Total Free Assets..... Deduct Liabilities Having Priority, per contra: Accrued Wages..... Net Free Assets..... Deficiency to Unsecured Creditors	300.00 4,000.00 1,500.00 13,500.00 <u>\$22,300.00</u> 250.00 <u>\$22,050.00</u> 3,750.00 <u>\$25,800.00</u>	18,000.00 25,000.00 10,000.00 1,050.00 25,000.00 10,000.00 1,050.00 \$55,300.00	Partially Secured Liabilities: Notes Payable... \$4,000.00 Deduct Bonds of X Co 3,200.00 \$ 800.00 Unsecured Liabilities: Accounts Payable..	4,000.00 3,200.00 \$ 800.00 25,000.00 Capital: Capital Stock Surplus
<u>\$25,000.00</u>	<u>\$25,800.00</u>	<u>\$55,300.00</u>		<u>\$25,800.00</u>

State, county, district, or municipality, in the order or priority as set forth in paragraph (b) hereof. . . .

“(b) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the actual and necessary cost of preserving the estate subsequent to filing the petition; (2) the filing fees paid by creditors in involuntary cases, and where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, shall have been recovered for the benefit of the estate of the bankrupt by the efforts and at the expense of one or more creditors, the reasonable expense of such recovery; (3) the cost of administration, including the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney’s fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the petitioning creditors in involuntary cases while performing the duties herein prescribed, and to the bankrupt in voluntary and involuntary cases as the court may allow; (4) where the confirmation of composition terms has been refused or set aside upon the objection and through the efforts and at the expense of one or more creditors, in the discretion of the court, the reasonable expenses of such creditors in opposing such composition; (5) wages due to workmen, clerks, traveling or city salesmen, or servants, which have been earned within three months before the date of the commencement of the proceeding, not to exceed \$600.00 to each claimant; (6) taxes payable under paragraph (a) hereof; and (7) debts owing to any person who by the laws of the States or the United States is entitled to priority: Provided, That the term person as used in this section shall include corporations, the United States and the several States and Territories of the United States.”

In some states rents are given priority by state law, and in such states liabilities for rent are entitled to priority under clause (7).

Liabilities having priority have usually been shown in the statement of affairs under the caption of Preferred Liabilities. However, “preference” has a different meaning under the

bankruptcy law, which provides that a debtor "shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class."

For purposes of precision in terminology, the author is taking the liberty of discontinuing the customary caption Preferred Liabilities in the statement of affairs and substituting the caption Liabilities Having Priority.

It will be noted that, in the statement of affairs, such liabilities are not extended to the Expected to Rank column, but are deducted from the total free assets in the Expected to Realize column, to indicate that they are a first claim against the free assets and that they must be settled in full before any assets are available for the payment of unsecured liabilities.

Fully secured liabilities and pledged assets.—A fully secured liability is a debt secured by pledged assets having a realizable value equal to or greater than the amount of the debt. Fully secured creditors realize on the pledged assets, deduct the amount of their claims, and pay any excess to the receiver or trustee; in the statement of affairs on page 128, the \$15,000.00 fully secured mortgage and the \$18,000.00 of pledged assets are shown as follows:

On the asset side:

The estimated value of the mortgaged land and buildings, \$18,000.00, is entered at the left of the Expected to Realize column, the amount of the mortgage is deducted, and the \$3,000.00 excess of the security over the liability is entered in the Expected to Realize column, to show the net amount which the trustee expects to obtain.

On the liability side:

The notation "deducted contra" and the omission of the

amount from the Expected to Rank column indicate that the mortgage will be paid from the proceeds of the pledged assets and not from the funds which are to come into the trustee's hands.

Partially secured liabilities and pledged assets.—A partially secured liability is a debt secured by assets having a realizable value less than the amount of the debt. Partially secured creditors realize on the pledged assets, apply the proceeds in reduction of their claims, and look to the trustee for payment of the unsecured balance. Therefore, as illustrated by the statement of affairs on page 128,

On the liability side:

The estimated value of the pledged bonds (\$3,200.00) is deducted from the amount of the liability (\$4,000.00), and the excess or unsecured portion of the liability (\$800.00) is extended to the Expected to Rank column, as a general claim against the free assets.

On the asset side:

The notation "deducted contra" and the omission of the estimated value from the Expected to Realize column indicate that the trustee will obtain no funds from the disposal of the bonds.

Unsecured liabilities and free assets.—All unsecured liabilities are entered in the Expected to Rank column, and the realizable values of all free assets are entered in the Expected to Realize column.

Capital.—The amounts of the capital stock and surplus are entered in the Book Value column on the liability side of the statement of affairs, to bring the two Book Value columns into balance and thus to indicate that no assets or liabilities shown by the balance sheet have been omitted from the statement of affairs.

Net free assets and deficiency to unsecured creditors.—The \$22,300.00 total of the Expected to Realize column is the amount of funds which the trustee expects will come into his possession. The liabilities having priority are deducted from this total to indicate that they are a first

claim against the free assets, and to determine the \$22,050.00 remainder, or net free assets, which it is estimated will be available for the payment of unsecured liabilities. The difference between the net free assets and the unsecured liabilities (shown by the total of the Expected to Rank column) is the deficiency to unsecured creditors.

The Deficiency account.—The statement of affairs should be accompanied by a statement called a Deficiency account showing the estimated loss or gain on the realization of the assets. This account, or statement, shows why it will be impossible to pay the unsecured creditors in full. The estimated losses and gains appear in the Deficiency account as follows:

THE SMITH COMPANY
Deficiency Account—June 30, 1933

Estimated Loss on:	Estimated Gain on:
Accounts Receivable ... \$3,500.00	Bonds of X Company.... \$200.00
Merchandise ... 4,500.00	
Land and Buildings..... 7,000.00	

The balance of this account now shows a loss of \$14,800.00. The account is closed by entering on the credit side:

- (1) The Capital Stock and Surplus of the corporation, thus indicating the loss to be borne by the stockholders; and
- (2) The Deficiency to Unsecured Creditors, per the statement of affairs, thus indicating the probable loss to be borne by the creditors.

THE SMITH COMPANY
Deficiency Account—June 30, 1933

Estimated Loss on:	Estimated Gain on:
Accounts Receivable... \$ 3,500.00	Bonds of X Company. \$ 200.00
Merchandise.... 4,500.00	Capital Stock..... 10,000.00
Land and Buildings.... 7,000.00	Surplus..... 1,050.00
	Deficiency to Creditors.. 3,750.00
<u>\$15,000 00</u>	<u>\$15,000.00</u>

Illustration of special points.—The statement of affairs and the Deficiency account on pages 134 to 136 illustrate the treatment of a number of special points discussed in the following sections.

Reserves.—The treatment of reserves depends upon their nature. For purposes of explanation and illustration, reserves may be classified as follows:

- (1) Valuation reserves, such as reserves for depreciation and for bad debts.

Such reserves are usually deducted from the gross book values of the assets, and the net book values are entered in the Book Value column on the asset side of the statement of affairs. This treatment is illustrated by the deduction of the reserves for depreciation of buildings and machinery. The Deficiency account shows, as a loss, the difference between the net book value and the estimated realizable value.

In some cases one reserve may be set up against two or more assets. For instance, in the illustrative statement, there is one reserve for losses on both accounts and notes receivable. Since this reserve cannot be apportioned between the two assets, it cannot be deducted on the asset side of the statement, and is therefore shown under the Reserve caption on the liability side of the statement. In the Deficiency account, the reserve is deducted from the gross loss on the accounts and notes.

- (2) Reserves for accrued liabilities.

Such reserves should be classified under the Prior, Fully Secured, Partially Secured, or Unsecured Liabilities caption if any real liability exists. If there is no liability, the reserve may be shown under the Reserve caption, with no amount extended to the Expected to Rank column. In the illustration, a reserve was provided for possible additional Federal income taxes of prior years; as it is expected that the tax will have to be paid, the item is classified as a liability having priority.

- (3) Contingent liabilities.

The three following contingent liabilities appear in the statement of affairs on page 134.

THE LUCAS MANUFACTURING COMPANY
Statement of Affairs—August 31, 1933

Assets

<u>Book Value</u>	<u>Ex-pected to Realize</u>	<u>Book Value</u>	<u>Ex-pected to Rank</u>
\$ 5,000			
21,000			
Assets Pledged with Fully Secured Creditors:			
Land—Estimated Value.....	\$ 5,350		
Buildings—Estimated Value.....	16,000		
\$27,500 Cost			
6,500 Reserve for Depreciation			
<u>\$21,000</u> Net Book Value			
12,500 Sinking Fund.....	12,250		
Total Security for Bonds Payable	<u>\$33,600</u>		
Deduct: Bonds Payable...	\$25,000		
Accrued Interest.....	500		
25,500 \$ 8,100			
Assets Pledged with Partially Secured Creditors:			
5,000 Bonds of Fairview Company—Estimated Value.....	\$ 4,850		
100 Accrued Interest on Bonds.....	100		
2,350 Finished Goods.....	1,200		
Total Security for \$10,000 of Notes Payable—deducted contra.....	<u>\$ 6,150</u>		
Free Assets:			
495 Cash.....	\$ 495		
Less Worthless Checks Held.....	210		
32,375 Accounts Receivable.....	19,800		
1,200 Notes Receivable.....	800		
Liabilities			
Liabilities Having Priority:			
Accrued Taxes—deducted contra		225	
Reserve for Federal Income Tax—deducted contra		425	
Fully Secured Liabilities:			
Bonds Payable—deducted contra		25,000	
Accrued Bond Interest—deducted contra		500	
Partially Secured Liabilities:			
Notes Payable.....	10,000		
Accrued Interest on Notes Payable.....	120		
Total.....	<u>120</u>		
Deduct Security—detailed per contra.....		\$10,120	
6,150 \$ 3,970			
Unsecured Liabilities:			
Notes Payable.....	25,000		
Accrued Interest on Notes Payable.....	355		
Accounts Payable.....	32,350		
Contingent Liabilities:			
Notes Receivable Discounted.....	400		
Reserve for Damage Suit	3,000		
Possible Liability for Non-Delivery of Merchandise.....			1,000

18	Accrued Interest on Notes Receivable.....	18		
5,900	Goods in Process			
	Estimated Value When Completed \$ 6,000			
	Less Cost to Complete:			
	Raw Materials Worth..... \$500			
	Other Expenditures..... 200	700		
7,000	Raw Materials	5,300		
	\$1,000 to be Used in Finishing Goods in Process.....	500		
	\$6,000 to be Sold.....	3,000		
5,000	Bonds of Fairview Company.....	4,850		
100	Accrued Interest on Bonds.....	100		
23,700	Machinery—Estimated Value.....	18,500		
	\$31,000 Appraised Value			
	7,300 Reserve for Depreciation			
	<u>\$23,700</u> Net Book Value			
10,000	Goodwill—No Value			
125	Unexpired Insurance			
500	Discount on Stock.....	300		
	Total Free Assets.....	\$61,553		
	Deduct Liabilities Having Priority—per contra	650		
	Net Free Assets.....	\$60,903		
	Deficiency to Creditors.....	2,172		
		<u>\$63,075</u>		
				<u>\$63,075</u>
				<u>\$132,363</u>
				<u>\$132,363</u>

THE LUCAS MANUFACTURING COMPANY

Deficiency Account—August 31, 1933

Deficit from Operations.....	\$ 9,012.00		
Estimated Loss on:		Estimated Gain on Land.....	\$ 350.00
Buildings.....		Reserve for Damage Suit—not required.....	3,000.00
Sinking Fund.....	5,000.00	Capital Stock.....	25,000.00
Bonds of Fairview Company.....	250.00	Sinking Fund Reserve.....	12,500.00
Finished Goods.....	300.00	Deficiency to Creditors.....	2,172.00
Cash.....	1,150.00		
	210.00		
Receivables:			
Accounts Receivable.....	\$12,575.00		
Notes Receivable.....	400.00		
Total.....	<u>\$12,975.00</u>		
Less Reserve for Losses.....	1,500.00		
Goods in Process.....	600.00		
Raw Materials.....	3,500.00		
Machinery:			
Net Book Value.....	\$23,700.00		
Less Unrealized Profit on Appraisal.....	5,000.00		
Cost Less Depreciation.....	<u>\$18,700.00</u>		
Less Estimated Realizable Value.....	200.00		
Goodwill.....	10,000.00		
Unexpired Insurance.....	125.00		
Discount on Stock.....	200.00		
Possible Liability for Non-Delivery of Merchandise.....	1,000.00		
			<u>\$43,022.00</u>

\$43,022.00

The company was contingently liable in the amount of \$400.00 on notes receivable discounted. The discounted notes will probably have to be paid by the indorser, and the \$400.00 is therefore extended to the Expected to Rank column. This \$400.00 is also, of course, included in the \$1,200.00 debit balance of the Notes Receivable account. Since it is expected that the remaining notes receivable will be collectible, \$800.00 is extended to the Expected to Realize column on the asset side.

The company had set up a \$3,000.00 reserve for possible payments to be made as damages under a pending suit. A favorable issue of the suit now appears probable, and therefore no liability is extended to the Expected to Rank column.

On the other hand, the company is in default on a contract for the delivery of goods and will probably be required to pay \$1,000.00 in settlement of damages. Although no reserve was set up, the item is shown under the Contingent Liabilities caption, with \$1,000.00 extended to the Expected to Rank column.

(4) Unrealized profit reserves.

When the company's machinery was appraised, a reserve was set up for the unrealized profit of \$5,000.00. This reserve is shown under the Reserves caption in the statement of affairs. It might have been deducted from the book value of the property on the asset side, thus:

\$18,700.00	Machinery
	\$31,000.00 Appraised Value
	7,300.00 Reserve for Depreciation
	<u>\$23,700.00</u> Net Book Value
	5,000.00 Unrealized Profit per Appraisal
	<u>\$18,700.00</u> Cost Less Depreciation

(5) Surplus reserves.

The illustrative statement of affairs contains one surplus reserve—the Sinking Fund Reserve. As it is a part of the net worth, it is classified under the Capital caption.

Accrued interest.—Accrued interest should appear in the statement of affairs immediately after the asset or liability on which the interest has accrued. If interest has accrued:

On an asset pledged as security, the interest as well as the principal should be shown as pledged. As an illustration, note the treatment of the accrued interest on the Fairview Company bonds under the caption, Assets Pledged with Partially Secured Creditors.

On a fully secured liability, the interest as well as the principal of the liability should be deducted from the security. As an illustration, note (under the caption, Assets Pledged with Fully Secured Creditors) the deduction of the bond principal and interest from the total security.

On a partially secured liability, the security should be deducted from the sum of the liability on principal and interest. For an illustration, refer to the data shown under the Partially Secured Liabilities caption.

Liabilities secured by more than one asset.—The statement of affairs on page 134 contains two illustrations of liabilities secured by more than one asset. Under the captions:

Assets Pledged with Fully Secured Creditors:

The company's land, buildings, and sinking fund are shown as security for the bonds payable.

Assets Pledged with Partially Secured Creditors:

Half of the company's Fairview bonds, the accrued interest thereon, and the finished goods are shown as security for the notes payable.

Unexpired insurance.—There is a difference of opinion among accountants as to whether the unexpired premiums on insurance policies should appear in the Expected to Realize column. While it is true that the unexpired premiums have a certain cash value at the time of preparing the statement of affairs, it is doubtful whether this value should be shown as a realizable asset. It cannot be realized without canceling the policies, and the policies cannot be safely canceled until the assets insured have been disposed of.

As it is not certain when the policies can be canceled, there is no way of knowing what, if anything, can be realized from the policies, and it therefore seems more conservative to give them no realizable value. The total unexpired premium can properly be shown in the Expected to Realize column of a statement prepared in support of a request for a loan (see page 142), because of its going-concern value.

Assets partly pledged and partly free.—The statement on pages 134 and 135 shows that \$5,000.00 par value of the Fairview Company bonds are pledged with partially secured creditors, and that the other \$5,000.00 par value are free and unpledged. In a balance sheet the \$10,000.00 total would probably be shown under one caption, but in a statement of affairs the pledged and unpledged status should be clearly indicated.

Deficit.—If a deficit appears in the balance sheet, it should not be shown on the asset side of the statement of affairs but should be deducted from the capital stock on the liability side, in the manner illustrated on page 135.

Stock discount.—When a Stock Discount account appears on the books of a corporation, the creditors have a right to the payment of the discount, or as much thereof as is necessary to pay the liabilities in full. If it is possible to make collections from the stockholders, a value should be carried to the Expected to Realize column. The Expected to Realize column may show only the amount necessary to collect in order to avoid a deficiency to creditors. For instance, if there is a \$10,000.00 Stock Discount account, and if, on the basis of the estimated realizable values of the assets, it appears necessary to collect \$7,000.00 of the discount, only \$7,000.00 need be entered in the Expected to Realize column. However, while it is true that no more will be collected from the stockholders than is necessary to pay the creditors in full, it seems desirable to show the full amount that can be collected, because of the possibility that the realizable values of the assets may have been overestimated. If this should prove to be true, there would be a corresponding increase in the amount to be collected from the stockholders,

and it seems desirable to have the statement of affairs show the maximum amount which could be collected. The facts may therefore be shown as follows:

<u>Book Value</u>	<u>Expected to Realize</u>
5,000.00	Discount on Stock
	Estimated Amount Collectible 4,000.00
	Estimated Amount Required to Pay Creditors in Full 2,000.00

Additional costs before realization.—It is sometimes necessary to make additional expenditures on assets before they can be realized to the best advantage. As an example, the statement of affairs on page 135 shows, under the Goods in Process caption, that this inventory, when completed, will probably realize \$6,000.00 but that raw materials worth \$500.00 and other expenditures of \$200.00 will be required for their completion. The proposed use, in the completion of goods in process, of raw materials having a realizable value of \$500.00, is also shown under the Raw Materials caption.

Accounts and notes payable.—There is a tendency to assume that notes payable rank ahead of accounts payable as liabilities. This is a false assumption. Notes do not rank ahead of accounts unless the holders of notes have some security. On the other hand, accounts may rank ahead of notes if the accounts are secured and the notes are not.

Loss to partners.—If the business is operated by a partnership, the deficiency to creditors may be brought down in the statement of affairs as shown in the illustration on page 141 because the creditors can collect from the partners' private resources.

This form of statement may be used to advantage when one of the partners is insolvent and it is desired to show his personal creditors what equity he will have in the assets of the partnership after liquidation. This statement shows that Jones will have an equity of \$600.00 which his creditors can attach, whereas Smith will have no equity for his creditors to attach.

Statement for credit purposes.—A statement of affairs may be submitted to a bank or other prospective creditor in

Deficiency to Unsecured Creditors—down..	3,750.00		
Estimated Loss to Partners	<u>\$25,800.00</u>		
Division of Loss, and Resulting Capitals:	<u>\$14,800.00</u>		
		<u>Jones</u>	<u>Smith</u>
Capitals per books	\$8,000.00	\$3,050.00	
Loss	7,400.00	7,400.00	
Balance	\$ 600.00	<u>\$4,350.00*</u>	
		<u>\$14,800.00</u>	<u>\$55,300.00</u>
		<u>\$14,800.00</u>	<u>\$55,300.00</u>
Total Unsecured Liabilities			<u>\$25,800.00</u>
Deficiency to Creditors—down			<u>\$ 3,750.00</u>
Capital:			
Jones, Capital			8,000.00
Smith, Capital			3,050.00
			<u>\$14,800.00</u>

* Debit balance.

THE SMITH COMPANY
Statement of Affairs—June 30, 1933

	Assets	Liabilities	
	<u>Book Value</u>		<u>Expected to Rank</u>
	<u>Realize</u>		
Assets Pledged with Fully Secured Creditors:			
Land and Buildings:			
Estimated Value.....	\$26,500.00		
Less Mortgage Payable—contra	<u>\$11,500.00</u>		
		\$ 250.00	
Assets Pledged with Partially Secured Creditors:			
Bonds of X Company—deducted contra			
Estimated Value.....	<u>\$ 3,200.00</u>		
		15,000.00	
		Fully Secured Liabilities:	
		Mortgage Payable—deducted contra	
		Partially Secured Liabilities:	
		Notes Payable....	\$4,000.00
		Deduct Bonds of	
		X Co.....	<u>3,200.00</u> \$ 800.00
Free Assets:			
Cash.....	300.00		
Accounts Receivable:			
\$7,000.00 Good.....	7,000.00		
2,000.00 Doubtful	<u>1,500.00</u>		
	<u>\$9,000.00</u>		
Merchandise.....	21,000.00		
Total Free Assets.....	<u>\$41,300.00</u>		
Deduct Liabilities Having Priority—per contra:			
Accrued Wages.....	250.00		15,250.00
			<u>\$25,800.00</u>
			Excess of Net Free Assets over
			Unsecured Liabilities....
			15,250.00
			<u>\$41,050.00</u>
			<u>\$55,300.00</u>

support of a request for unsecured credit. The statement of affairs might be considered preferable to a balance sheet for that purpose because it shows the realizable values as well as the book values of the assets, and because the offsets of secured liabilities against pledged assets are clearly reflected.

If a statement of affairs is used for credit purposes, it will presumably show an excess of free assets over unsecured claims, thus indicating that the business is in such a good financial condition that all creditors may expect to be paid in full.

To illustrate the form of a statement of affairs for credit purposes, we may use the balance sheet of The Smith Company appearing on page 127 and increase the estimated realizable values of the assets. The illustrative statement appears on page 142.

CHAPTER 39

RECEIVER'S ACCOUNTS

Opening new books.—It is rarely necessary to open new books for a company in financial difficulties unless the business is to be operated by a receiver in equity. The old books may be continued if the business is to be liquidated under bankruptcy proceedings or by an assignee under a voluntary assignment, or if the operations are to be continued under the supervision of a representative of the creditors.

If operations are to be continued under the direction of a receiver in equity, it is usually desirable to open new books, to indicate that there has been a transfer of assets to the receiver, and to distinguish clearly between liabilities incurred prior to the receivership, which will be left on the old books, and liabilities incurred by the receiver, which will be recorded on the new books.

The order of the court appointing the receiver usually states the assets to which he is to take title; these assets may include part or all of the corporation's property. The receiver should open his books by taking up these assets as well as any valuation reserves against them. But he should not take the liabilities onto his books. The liabilities existing prior to the receivership should remain on the corporation's books, so as to maintain a distinction between prior and subsequent debts.

The entries on both sets of books showing the transfer of the assets, are:

<u>Receiver's Books</u>	<u>Corporation's Books</u>
Assets taken over	<i>M</i> —Receiver
Reserves against Assets	Reserves against Assets
X Y Z Co.—In Receivership	Assets

Payment of prior liabilities.—Although the receiver does not take the liabilities onto his books, he may be ordered by the court to pay them. In that case he should debit the

corporation and credit cash. But his debit entry should not be made in the account which was credited with the assets; temporary accounts with the corporation should be set up to furnish detailed information which the receiver will need in preparing his reports. The entries on both sets of books showing the payment of liabilities existing prior to the receivership, are:

<u>Receiver's Books</u>	<u>Corporation's Books</u>
X Y Z Co.—Bonds Paid	Bonds Payable
Cash	M—Receiver

Since the liabilities appear on the corporation's books instead of on the receiver's books, the accrued interest should be recorded on the corporation's books. The receiver, however, will be expected to pay the interest, and the entries should be made in such a way as to distinguish between interest accrued prior to the receivership and interest accrued during the receivership, thus:

<u>Receiver's Books</u>	<u>Corporation's Books</u>
X Y Z Co.—Accrued Interest Paid	Accrued Interest
Cash	M—Receiver
X Y Z Co.—Interest Paid	Interest
Cash	M—Receiver

Recording operations.—The expenses and income of operations should be recorded on the receiver's books, and so far as possible the receiver should follow the same classification of accounts as the corporation formerly used, in order that comparative statements can be made for the receivership and prior periods.

<u>Receiver's Books</u>	<u>Corporation's Books</u>
Various Expense accounts	
Cash or Accounts Payable	•
Cash or Accounts Receivable	
Sales	•
Cash or Accounts Receivable	
Other Income accounts	

Closing the books.—At the end of the regular accounting periods, and more frequently if desired, the receiver's books should be closed. This closing follows the regular routine,

and no special points are involved except that the Profit and Loss account is closed to the account with the company in receivership. After the receiver has made up his statements, the special accounts with the company showing liabilities carried on the company books but paid by the receiver, should be closed to the main account with the company.

The corporation takes up the profit or loss shown by the receiver, by debiting the receiver's account and crediting Profit and Loss for a profit, or by debiting Profit and Loss and crediting the receiver if a loss is incurred. Any nominal accounts on the corporation's books are then closed to Profit and Loss, and the net profit or loss thus determined is closed to Surplus.

Periodical statements.—The statements prepared at the end of each accounting period should include a profit and loss statement and a balance sheet, which should embody the information recorded in both the company's books and the receiver's books. The balances shown by the two sets of books may be assembled on working papers provided with columns for the trial balances of the two ledgers, as illustrated on page 154.

Close of the receivership.—When the receivership is terminated, the receiver should close his books by recording the return to the corporation of such assets as he holds. Entries recording the termination of the receivership should be made on both sets of books as follows:

<u>Receiver's Books</u>	<u>Corporation's Books</u>
X Y Z Co.—In Receivership	Assets
Reserves	Reserves
Assets	M—Receiver

If any unpaid liabilities appear on the receiver's books, they should also be transferred to the company's books.

Illustration

Basis of illustration.—The *C* Company found itself in financial difficulties, and F. C. White was appointed receiver as of June 30, 1934. The books were closed, and the balance sheet shown on page 148 was prepared.

RECEIVER'S ACCOUNTS

C COMPANY

Balance Sheet—June 30, 1934

Assets	
Current Assets:	
Cash.....	\$ 1,800.00
Accounts Receivable.....	\$50,000.00
Less Reserve for Bad Debts.....	<u>1,500 00</u> 48,500.00
Notes Receivable.....	15,000.00
Inventory.....	<u>60,000 00</u>
Total Current Assets.....	\$125,300 00
Marketable Securities.....	7,500.00
Fixed Assets:	
Land.....	\$10,000.00
Building.....	\$80,000.00
Less Reserve for Depreciation... ..	<u>15,000.00</u> 65,000.00
Furniture and Fixtures... ..	\$10,000 00
Less Reserve for Depreciation.....	<u>3,000 00</u> 7,000.00
Total Fixed Assets.....	82,000.00
Deferred Charges:	
Unexpired Insurance.....	900 00
	<u>\$215,700.00</u>
Liabilities	
Current Liabilities:	
Accounts Payable.....	\$95,000 00
Notes Payable.....	25,000.00
Accrued Mortgage Interest.....	<u>500.00</u>
Total Current Liabilities.....	\$120,500.00
Fixed Liabilities:	
Mortgage Payable.....	50,000.00
Net Worth:	
Capital Stock.....	\$50,000.00
Less Deficit.....	<u>4,800.00</u>
Net Worth.....	45,200.00
	<u>\$215,700.00</u>

On pages 150–153 will be found the entries, in journal form, recording the following facts on the books of the receiver and the books of the company. The transactions cover a period of a year.

- (a) The receiver, under order of the court, took over all of the assets shown by the foregoing balance sheet. Note that the receiver, in taking up the accounts receivable, debits Accounts Receivable—Old to distinguish them from accounts receivable which will result from sales during the receivership.
- (b) Merchandise purchases on account, \$120,000.00.

- (c) Sales on account, \$200,000.00.
- (d) Cash collections amounting to \$47,500.00 were obtained on the old accounts receivable. The remaining accounts were written off as worthless, by charges to the Reserve for Bad Debts and to a special loss account.
- (e) The notes receivable, \$15,000.00, were collected in full.
- (f) Interest in the amount of \$300.00 was collected on these notes.
- (g) New accounts receivable amounting to \$160,000.00 were settled by cash collections of \$157,700.00 and the allowance of cash discounts of \$2,300.00.
- (h) Interest in the amount of \$120.00 was collected on the marketable securities.
- (i) The marketable securities were sold for \$7,350.00, or at a loss of \$150.00.
- (j) Prior liabilities were paid as follows:

Accounts payable.....	\$95,000.00
Notes payable.....	25,000.00
Mortgage installment....	5,000.00
Mortgage interest accrued on June 30, 1934 . . .	500.00

- (k) The mortgage interest accrued from June 30, 1934 to June 30, 1935, was \$2,950.00.
- (l) The receiver paid the accrued mortgage interest from June 30, 1934 to April 30, 1935, in the amount of \$2,500.00.
- (m) Receiver's accounts payable for merchandise purchases, in the amount of \$75,000.00, were settled as follows: Cash payments were made in the amount of \$73,600.00; and cash discounts were taken in the amount of \$1,400.00.
- (n) The following expenses were paid in cash:

Salaries and Wages.....	\$17,000.00
Freight In.....	350.00
Delivery Expense.....	1,000.00
Taxes.....	1,200.00
General Expense.....	7,500.00

- (o) Depreciation for the year was provided in the following amounts:

Building.....	\$3,200.00
Furniture and Fixtures.....	1,000.00

- (p) A reserve for bad debts in the amount of \$1,200.00 was provided against the new accounts receivable.
- (q) The insurance premium expiration for the year, chargeable to operations, was \$550.00.

The merchandise inventory on June 30, 1935, was \$23,000.00.

RECEIVER'S ACCOUNTS

Receiver's Books

(a) Cash.....	1,800	
Accounts Receivable—Old.....	50,000	
Notes Receivable.....	15,000	
Inventory.....	60,000	
Marketable Securities.....	7,500	
Land.....	10,000	
Building.....	80,000	
Furniture and Fixtures.....	10,000	
Unexpired Insurance.....	900	
Reserve for Bad Debts—Old.....		1,500
Reserve for Depreciation—Building .. .		15,000
Reserve for Depreciation—Furniture and Fixtures.		3,000
C Company—In Receivership.....		215,700
To open the receiver's books.		
(b) Purchases.....	120,000	
Accounts Payable.....		120,000
Purchases of merchandise.		
(c) Accounts Receivable—New.....	200,000	
Sales.....		200,000
Sales on account.		
(d) Cash.....	47,500	
Reserve for Bad Debts—Old.....	1,500	
Loss on Accounts Receivable—Old.....	1,000	
Accounts Receivable—Old.....		50,000
Collections on old accounts receivable.		
(e) Cash.....	15,000	
Notes Receivable.....		15,000
Collection of notes in full.		
(f) Cash.....	300	
Interest Income.....		300
Interest collected on notes.		
(g) Cash.....	157,700	
Discount on Sales.....	2,300	
Accounts Receivable—New.....		160,000
Collections on new accounts receivable.		
(h) Cash.....	120	
Interest Income		120
Collected on securities.		
(i) Cash.....	7,350	
Loss on Securities.....	150	
Marketable Securities.....		7,500
Sale of securities.		
(j) C Company—Accounts Payable Paid.....	95,000	
C Company—Notes Payable Paid.....	25,000	
C Company—Mortgage Payments.....	5,000	
C Company—Mortgage Interest Paid.....	500	
Cash.....		125,500
Payment of prior liabilities.		

RECEIVER'S ACCOUNTS

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Company's Books

(a)	F. C. White—Receiver	215,700
	Reserve for Bad Debts	1,500
	Reserve for Depreciation—Building	15,000
	Reserve for Depreciation—Furniture and Fixtures	3,000
	Cash	1,800
	Accounts Receivable	50,000
	Notes Receivable	15,000
	Inventory	60,000
	Marketable Securities	7,500
	Land	10,000
	Building	80,000
	Furniture and Fixtures	10,000
	Unexpired Insurance	900
	To charge the receiver with the assets taken over.	

(j)	Accounts Payable	95,000
	Notes Payable	25,000
	Mortgage Payable	5,000
	Accrued Mortgage Interest	500
	F. C. White—Receiver	125,500
	Liabilities paid by receiver.	

RECEIVER'S ACCOUNTS

Receiver's Books

(l) C Company—Mortgage Interest Paid.....	2,500	
Cash.....		2,500
Payment of interest from June 30, 1934 to April 30, 1935.		
(m) Accounts Payable.....	75,000	
Cash.....		73,600
Discount on Purchases.		1,400
Payment for purchases.		
(n) Salaries and Wages.....	17,000	
Freight In.....	350	
Delivery Expense.....	1,000	
Taxes	1,200	
General Expense.	7,500	
Cash.....		27,050
Payment of expenses.		
(o) Depreciation—Building.....	3,200	
Depreciation—Furniture and Fixtures...	1,000	
Reserve for Depreciation—Building		3,200
Reserve for Depreciation—Furniture and Fixtures.		1,000
Depreciation provisions for the year.		
(p) Bad Debts—Receiver's Sales.....	1,200	
Reserve for Bad Debts—New...		1,200
Provision for losses.		
(q) Insurance.....	550	
Unexpired Insurance.....		550
To write off insurance expired during year.		

RECEIVER'S ACCOUNTS

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		<u>Company's Books</u>	
(k)	Mortgage Interest.....	2,950	
	Accrued Mortgage Interest.....		2,950
	Interest for year ended June 30, 1935.		
(l)	Accrued Mortgage Interest.....	2,500	
	F. C. White—Receiver.....		2,500
	Payment of interest from June 30, 1934 to April 30, 1935.		

C COMPANY—IN RECEIVERSHIP

Working Papers

For the Year Ended June 30, 1935

	Receiver's Trial Balance	Company's Trial Balance	Eliminations	Profit and Loss	Balance Sheet
Cash.....	1,120				1,120
Accounts Receivable—New.....	40,000				40,000
Reserve for Bad Debts—New.....	60,000	1,200		60,000	1,200
Inventory—June 30, 1934.....	10,000				10,000
Land.....	80,000				80,000
Building.....	18,200				18,200
Reserve for Depreciation—Building.....					
Furniture and Fixtures.....	10,000	4,000			10,000
Reserve for Depreciation—Furniture and Fixtures.....	350				4,000
Unexpired Insurance.....					
Accounts Payable.....		45,000			350
Accrued Mortgage Interest.....		450			45,000
Mortgage Payable.....		45,000			45,000
Capital Stock.....		50,000			50,000
Shareholders' Equity.....		4,800			
F. C. White—Receiver.....		87,700	87,700		4,800
C. Company—In Receivership.....		215,700	215,700		
C. Company—Accounts Payable Paid.....	95,000		95,000		
C. Company—Notes Payable Paid.....	25,000		25,000		
C. Company—Mortgage Payable Paid.....	5,000		5,000		
C. Company—Mortgage Payments.....	3,000		3,000		
C. Company—Mortgage Interest Paid.....					
Sales.....	200,000			200,000	
Purchases.....	120,000			120,000	
Freight In.....	350			350	
Salaries and Wages.....	17,000			17,000	
Delivery Expense.....	1,000			1,000	
Taxes.....	1,200			1,200	
Insurance.....	1,550			1,550	
General Expense.....	7,500			7,500	
Depreciation—Building.....	3,200			3,200	
Depreciation—Furniture and Fixtures.....	1,000			1,000	
Bad Debts.....	1,200			1,200	
Discount on Sales.....	2,300			2,300	
Discount on Purchases.....		1,400			1,400
Interest Income.....		420			420
Mortgage Interest.....					
Loss on Accounts Receivable—Old.....	1,000	2,950		2,950	
Loss on Securities.....	150			1,150	
Inventory—June 30, 1935.....	485,920	95,450	215,700	23,000	23,000
Net Income.....	485,920	95,450	215,700	5,420	5,420
				224,820	169,270
					5,420
					169,270

Working papers.—The working papers assembling the balances on the receiver's books and on the company's books appear on page 154. These working papers contain the information required for the balance sheet appearing below, and for the profit and loss statement on page 156.

Balance sheet.—The balance sheet as of June 30, 1935, prepared from the working papers, appears below.

C COMPANY—IN RECEIVERSHIP

F. C. WHITE—RECEIVER

Balance Sheet—June 30, 1935

Assets	
Current Assets:	
Cash.....	\$ 1,120.00
Accounts Receivable—New.....	\$40,000.00
Less Reserve for Bad Debts.....	1,200.00
Inventory.....	23,000.00
Total Current Assets.....	\$ 62,920.00
Fixed Assets:	
Land.....	\$10,000.00
Building.....	\$80,000.00
Less Reserve for Depreciation.....	18,200.00
Depreciated Value.....	61,800.00
Furniture and Fixtures.....	\$10,000.00
Less Reserve for Depreciation.....	4,000.00
Total Fixed Assets.....	77,800.00
Deferred Charges:	
Unexpired Insurance.....	350.00
	\$141,070.00
Liabilities	
Current Liabilities:	
Accounts Payable.....	\$45,000.00
Accrued Mortgage Interest.....	450.00
Total Current Liabilities.....	\$ 45,450.00
Fixed Liabilities:	
Mortgage Payable.....	45,000.00
Net Worth:	
Capital Stock.....	\$50,000.00
Surplus:	
Deficit, June 30, 1934.....	\$ 4,800.00
Surplus for the Year.....	5,420.00
	620.00
	50,620.00
	\$141,070.00

Profit and loss statement.—The profit and loss statement for the year ended June 30, 1935, showing the results of operations as recorded on the books of the receiver and those of the company, appears on page 156.

RECEIVER'S ACCOUNTS

C COMPANY—IN RECEIVERSHIP

F. C. WHITE—RECEIVER

Profit and Loss Statement

For the Year Ended June 30, 1935

Sales.....			\$200,000.00
Less Cost of Goods Sold:			
Inventory, June 30, 1934.....	\$ 60,000.00		
Purchases.....	\$120,000.00		
Freight In.....	350 00	120,350.00	
Total.....		\$180,350.00	
Less Inventory, June 30, 1935....		23,000.00	
Remainder—Cost of Goods Sold			157,350 00
Gross Profit on Sales.....			\$ 42,650.00
Less Operating Expenses:			
Salaries and Wages.....	\$ 17,000 00		
Delivery Expense.....	1,000 00		
Taxes.....	1,200 00		
Insurance.....	550.00		
General Expense.....	7,500.00		
Depreciation:			
Building.....	3,200.00		
Furniture and Fixtures.....	1,000.00		
Bad Debts—Receiver's Sales.....	1,200.00		
Total Operating Expenses... ..			32,650.00
Net Operating Profit.....			\$ 10,000.00
Interest and Discount—Receiver's Operations:			
Discount on Sales.....	\$ 2,300.00		
Deduct:			
Discount on Purchases.....	\$ 1,400.00		
Interest Income.....	420.00	1,820.00	480.00
Net Income before Realization Losses and Mortgage Interest... ..			\$ 9,520.00
Deduct Realization Losses:			
Marketable Securities.....	\$ 150 00		
Accounts Receivable—Old.....	1,000.00	1,150.00	
Net Income before Mortgage Interest.....			\$ 8,370.00
Deduct Mortgage Interest.....			2,950.00
Net Increase in Surplus during the Year.....			<u>\$ 5,420.00</u>

Closing the books.—The following entries show the procedure of closing both sets of books.

Receiver's Books

Sales.....	200,000.00	
Profit and Loss.....		200,000.00
To close the Sales account.		
Profit and Loss.....	180,350.00	
Inventory—June 30, 1934.....		60,000.00
Purchases.....		120,000.00
Freight In.....		350.00
To close accounts showing merchandise costs.		

RECEIVER'S ACCOUNTS

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Inventory—June 30, 1935.....	23,000.00	
Profit and Loss.....		23,000.00
To set up the inventory at the end of the year.		
Profit and Loss.....	32,650.00	
Salaries and Wages.....		17,000.00
Delivery Expense.....		1,000.00
Taxes.....		1,200.00
Insurance.....		550.00
General Expense.....		7,500.00
Depreciation—Building.....		3,200.00
Depreciation—Furniture and Fixtures.....		1,000.00
Bad Debts.....		1,200.00
To close the expense accounts.		
Discount on Purchases.....	1,400.00	
Interest Income.....	420.00	
Profit and Loss.....	480.00	
Discount on Sales.....		2,300.00
To close the interest and cash discount accounts.		
Profit and Loss.....	1,150.00	
Loss on Accounts Receivable—Old.....		1,000.00
Loss on Securities.....		150.00
To close out the realization losses.		
Profit and Loss.....	8,370.00	
C Company—In Receivership.....		8,370.00
To close the Profit and Loss account.		
C Company—In Receivership.....	128,000.00	
C Company—Accounts Payable Paid.....		95,000.00
C Company—Notes Payable Paid.....		25,000.00
C Company—Mortgage Payments.....		5,000.00
C Company—Mortgage Interest Paid.....		3,000.00
To close the temporary accounts showing liability payments.		

Corporation's Books

F. C. White—Receiver.....	8,370.00	
Profit and Loss.....		8,370.00
To take up the net profit before mortgage interest, as shown by the receiver's books.		
Profit and Loss.....	2,950.00	
Mortgage Interest.....		2,950.00
To close the interest account.		
Profit and Loss.....	5,420.00	
Surplus.....		5,420.00
To close net income to Surplus.		

Reconciliation of reciprocal accounts.—After the two sets of books have been closed, trial balances should be drawn off and a statement should be prepared to reconcile the reciprocal accounts and to prove that the accounts on the two sets of books agree with the balance sheet.

RECEIVER'S ACCOUNTS

Working Papers After Closing

Debits	Re- ceiver's Books	Com- pany's Books	Elimi- na- tions	Com- bined
Cash.....	\$ 1,120			\$ 1,120
Accounts Receivable—New.....	40,000			40,000
Inventory.....	23,000			23,000
Land.....	10,000			10,000
Building.....	80,000			80,000
Furniture and Fixtures.....	10,000			10,000
Unexpired Insurance.....	350			350
F. C. White—Receiver.....		\$96,070	\$96,070	
	<u>\$164,470</u>	<u>\$96,070</u>	<u>\$96,070</u>	<u>\$164,470</u>
Credits				
Accounts Payable.....	\$ 45,000			\$ 45,000
Accrued Mortgage Interest.....		\$ 450		450
Mortgage Payable.....		45,000		45,000
Reserve for Bad Debts.....	1,200			1,200
Reserve for Depreciation—Building....	18,200			18,200
Reserve for Depreciation—Furniture and Fixtures.....	4,000			4,000
C Company—In Receivership.....	96,070		\$96,070	
Capital Stock.....		50,000		50,000
Surplus.....		620		620
	<u>\$164,470</u>	<u>\$96,070</u>	<u>\$96,070</u>	<u>\$164,470</u>

Close of the receivership.—If the receivership is terminated at this point, an entry should be made on the receiver's books as follows:

Accounts Payable.....	45,000	
Reserve for Bad Debts.....	1,200	
Reserve for Depreciation—Building.....	18,200	
Reserve for Depreciation—Furniture and Fixtures.....	4,000	
C Company—In Receivership.....	96,070	
Cash.....		1,120
Accounts Receivable—New.....		40,000
Inventory.....		23,000
Land.....		10,000
Building.....		80,000
Furniture and Fixtures.....		10,000
Unexpired Insurance.....		350

To close the receiver's books, recording the termination of the receivership.

The company's books should contain a contra entry, debiting the assets, crediting the liabilities and reserves, and crediting F. C. White—Receiver for the net assets.

CHAPTER 40

REALIZATION AND LIQUIDATION ACCOUNT

Purpose.—Statements in the form illustrated in this chapter may be used to show a court or the creditors of an insolvent business what has been accomplished, during a stated period of time, in the realization of assets and the liquidation of liabilities, what expenses have been incurred, and what income has been earned. The statement is usually supplemented by a cash account, a profit and loss statement, and a balance sheet.

The statement is called an account because it is drawn up in account form with debit and credit sides; it should be called a statement because it does not appear in the ledger.

Elements of the statement.—As shown by the illustration on the following page, this statement shows the following facts:

With respect to assets:

Assets To Be Realized
(Assets at the opening
date of the statement)
Assets Acquired
(Additional assets dis-
covered or acquired)

Assets Realized
(Proceeds from disposal of
assets)
Assets Not Realized
(Assets at closing date of
statement)

With respect to liabilities:

Liabilities Liquidated
(Payments to creditors)
Liabilities Not Liquidated
(At closing date of state-
ment)

Liabilities 'to Be Liquidated
(At opening date of state-
ment)
Liabilities Assumed
(Discovered or incurred)

With respect to expense and income:

Supplementary Charges
(Expenses)

Supplementary Credits
(Income)

JAMES BUTLER
F. S. MONTGOMERY—TRUSTEE IN BANKRUPTCY
 Realization and Liquidation Account
 June 16, 1934 to August 31, 1934

Assets To Be Realized:		
(a) Land and Buildings.....	\$14,500.00	
(a) Merchandise.....	8,000.00	
(a) Accounts Receivable.....	7,000.00	
(a) Notes Receivable.....	<u>3,000.00</u>	\$32,500.00
Liabilities To Be Liquidated:		
(a) Accounts Payable.....		\$28,000.00
Liabilities Assumed:		
(b) Accounts Payable.....		500.00
Assets Acquired:		
(b) Merchandise.....	500.00	10.00
Supplementary Charges:		
(g) Expense.....	200.00	
Liabilities Liquidated:		
(h) Accounts Payable.....	11,000.00	12,000.00
Liabilities Not Liquidated:		
Accounts Payable.....	17,500.00	\$ 2,500.00
		<u>14,500.00</u>
Loss on Realization.....		4,190.00
		<u><u>\$61,700.00</u></u>

REALIZATION AND LIQUIDATION ACCOUNT 161

Components of loss or gain.—It is usually difficult to understand why this statement, which shows facts with respect to assets and liabilities as well as facts with respect to income and expense, should have a balance showing a loss or a gain. The reason should be apparent from the following regrouping of the major items of the statement:

Facts about Assets:

Debit side of statement:

Assets to be realized.....	\$32,500.00	
Assets acquired.....	500.00	\$33,000.00

Credit side of statement:

Assets realized	\$12,000.00	
Assets not realized.....	17,000.00	29,000.00

Loss on realization of assets..... **\$4,000.00**

Facts about Liabilities:

Credit side of statement:

Liabilities to be liquidated.....	\$28,000.00	
Liabilities assumed.....	500.00	\$28,500.00

Debit side of statement:

Liabilities liquidated.....	\$11,000.00	
Liabilities not liquidated.....	17,500.00	28,500.00

Gain or loss—none..... —

Facts about Expense and Income:

Supplementary charges—expenses.....	\$ 200.00	
Supplementary credits—income.....	10.00	190.00

Net Expense..... 190.00

Net Loss..... **\$4,190.00**

Trustee's cash account.—The cash account to accompany the statement on page 160 is shown below:

JAMES BUTLER

F. S. MONTGOMERY—TRUSTEE IN BANKRUPTCY

Cash Account

June 16, 1934 to August 31, 1934

(a) Balance—June 16... \$ 700.00	(g) Expense..... \$ 200.00
(c) Merchandise..... 5,500.00	(h) Accounts Payable... 11,000.00
(d) Accounts Receivable. 4,500.00	Balance—August 31. 1,510.00
(e) Notes Receivable.... 2,000.00	
(f) Int. on Notes Rec... 10.00	
\$12,710.00	\$12,710.00

Procedure in preparing statements.—The letters in the cash account and in the realization and liquidation account on page 160 are included merely for purposes of explanation in this chapter.

162 REALIZATION AND LIQUIDATION ACCOUNT

The preparation of the realization and liquidation account and the accompanying cash account will not be found difficult or confusing if they are built up by offsetting debit and credit entries. The following entries should be traced to the statements:

- (a) The assets, liabilities, and capital as of June 16 are "journalized" in the statements as follows:

Debits: Under Assets To Be Realized—all assets other than cash.

In the cash account—the opening cash balance.

Credits: Under Liabilities To Be Liquidated—all liabilities.

In a memorandum Capital account—the opening net worth, thus:

Memorandum Capital Account

(a) Net Worth June 16. . . . 5,200 00

- (b) Merchandise was purchased at a cost of \$500.00:
Debit: Under Assets Acquired—the cost of the merchandise.
Credit: Under Liabilities Assumed—the amount of the account payable.
- (c) Merchandise was sold for cash, \$5,500.00:
Debit: In the cash account.
Credit: Under Assets Realized.
- (d) Accounts receivable were collected in the amount of \$4,500.00:
Debit: In the cash account.
Credit: Under Assets Realized.
- (e) Notes receivable were collected in the amount of \$2,000.00:
Debit: In the cash account.
Credit: Under Assets Realized.
- (f) Interest on notes receivable was collected in the amount of \$10.00:
Debit: In the cash account.
Credit: Under Supplementary Credits.
- (g) Expenses were paid in the amount of \$200.00:
Debit: Under Supplementary Charges.
Credit: In the cash account.
- (h) Accounts payable were paid in the amount of \$11,000.00:
Debit: Under Liabilities Liquidated.
Credit: In the cash account.

To complete the realization and liquidation account, the assets (other than cash) at the end of the period were entered under the Assets Not Realized caption; the unpaid liabilities were entered under the Liabilities Not Liquidated caption; and the Loss on Realization was entered to balance the statement.

To prove the loss shown in the realization and liquidation account, the following realization profit and loss statement was prepared:

JAMES BUTLER
F. S. MONTGOMERY—TRUSTEE IN BANKRUPTCY
 Realization Profit and Loss Statement
 July 16, 1934 to August 31, 1934

Losses on Realization:	
Merchandise	\$3,000.00
Notes Receivable	1,000.00
Total	\$4,000.00
Expense	200.00
Total Loss and Expense	\$4,200.00
Deduct Interest on Notes Receivable	10.00
Net Loss	<u>\$4,190.00</u>

This loss was then deducted from the \$5,200.00 credit in the memorandum Capital account (which showed the net worth at the beginning of the period) to determine the net worth of \$1,010.00 at the end of the period; and the following balance sheet was prepared from the data shown by the Assets Not Realized and the Liabilities Not Liquidated sections of the realization and liquidation account, by the balance in the cash account, and by the balance in the memorandum Capital account.

JAMES BUTLER
F. S. MONTGOMERY—TRUSTEE IN BANKRUPTCY
 Balance Sheet—August 31, 1934

Assets	Liabilities
Accounts Receivable \$ 2,500.00	Accounts Payable \$17,500.00
Land and Buildings 14,500.00	James Butler, Capital 1,010.00
Cash 1,510.00	
<u>\$18,510.00</u>	<u>\$18,510.00</u>

Reserves.—If reserves have been set up against the assets, they should be deducted from the assets in the Assets To Be Realized section, thus:

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Assets To Be Realized:		
Timber Lands.....	\$300,000.00	
Less Reserve for Depletion.....	75,000.00	\$225,000.00
Machinery.....	\$ 15,000.00	
Less Reserve for Depreciation...	3,000.00	12,000.00
Accounts Receivable.....	\$ 1,250.00	
Less Reserve for Bad Debts.....	350 00	900.00

When the assets not realized are entered at the close of the statement, the reserves should again be deducted. Assuming that the operations of the business have been carried on by a receiver in equity, that \$5,000.00 depletion and \$600.00 depreciation have been charged off, and that \$700.00 of the accounts receivable have been collected, while \$100.00 has been charged to the reserve, the accounts would be shown thus:

Assets Not Realized:		
Timber Lands.....	\$300,000.00	
Less Reserve for Depletion.....	80,000.00	\$220,000.00
Machinery.....	\$ 15,000.00	
Less Reserve for Depreciation...	3,600.00	11,400.00
Accounts Receivable.....	\$ 450.00	
Less Reserve for Bad Debts.....	250.00	200.00

The \$5,000.00 depletion and the \$600.00 depreciation would appear in the realization profit and loss statement, but the \$100.00 loss on accounts receivable would not appear in the profit and loss statement, because the loss was absorbed in the reserve.

Sales and purchases.—If business operations are continued during the receivership, the materials or merchandise purchased may be shown in the realization and liquidation account as Assets Acquired or as Supplementary Charges, and sales may be shown as Assets Realized or as Supplementary Credits.

Accruals.—The question of accruals presents some difficulty. To illustrate, assume that \$15.00 of accrued interest on notes receivable is shown in the Assets To Be Realized section. By the time the notes are collected, \$5.00 additional interest has accrued, so that \$20.00 is collected. The accrual and the collection of interest may be handled in either of two ways:

First method:

Cash.....	20 00	
Assets Realized.....		15 00
Supplementary Credits.....		5 00

Second method:

Assets Acquired (Accrued Interest).....	5 00	
Supplementary Credits.....		5 00
Cash.....	20 00	
Assets Realized.....		20 00

Similar methods may be used for accrued expenses.

Discounts.—Two methods are available for dealing with discounts and allowances, either to customers or from creditors. To illustrate, assume that \$8,000.00 of accounts receivable are taken over by the receiver, who continues operations. Discounts of \$75.00 and allowances of \$150.00 are given to the customers, and the balance is collected in full. The two methods of dealing with the discounts and allowances are shown below.

First method:

Assets To Be Realized:		Assets Realized:	
Accounts Receivable....	\$8,000.00	Accounts Receivable...	\$7,775.00

By this method, the discounts and allowances are not shown, but the \$225.00 excess of debits over credits will be included in the loss on realization.

Second method:

Assets To Be Realized:		Assets Realized:	
Accounts Receivable....	\$8,000.00	Accounts Receivable:	
Supplementary Charges:		Discounts \$	75 00
Discounts to		Allowances	150 00
Customers... \$	75 00	Cash.....	<u>7,775.00</u> \$8,000.00
Allowances to			
Customers... <u>150.00</u>	225 00		

Similar methods may be used for discounts and allowances from creditors.

Premium or discount on securities.—If securities owned are sold at a profit or a loss, the profit or the loss is not shown

166 REALIZATION AND LIQUIDATION ACCOUNT

as a separate item. The book value is shown under Assets To Be Realized, and the price received is shown under Assets Realized. But if outstanding bonds or other liabilities are redeemed at a premium or a discount, the face of the liability should be shown under Liabilities Liquidated; any discount on redemption should be shown under Supplementary Credits, and any premium on redemption should be shown under Supplementary Charges.

To illustrate, assume that a company holds \$5,000.00 of bonds for which it paid par; these bonds are sold for \$4,960.00. The company also has \$20,000.00 of bonds outstanding which are redeemed for \$19,000.00. The facts may be shown thus:

Realization and Liquidation Account	
Assets To Be Realized: Bonds of X Company.. \$ 5,000.00	Liabilities To Be Liquidated: Bonds Payable..... \$20,000.00
Liabilities Liquidated: Bonds Payable..... 20,000.00	Supplementary Credits: Discount on Bonds Payable..... 1,000.00
	Assets Realized: Bonds of X Company. 4,960.00

Composition with creditors.—If creditors agree to accept a certain number of cents on the dollar, the old indebtedness is, according to law, canceled by the agreement and a new indebtedness takes its place. Assume that there were \$20,000.00 of accounts payable, that the creditors agreed to accept seventy-five cents on the dollar, and that twenty cents (of the seventy-five) had been paid at the time of preparing the realization and liquidation account; the facts would be shown as follows:

Liabilities Liquidated: Accounts Payable—settled at 75¢ on the dollar..... \$20,000 Accounts Payable—pay- ments under composition agreement..... 4,000	Liabilities To Be Liquidated: Accounts Payable..... \$20,000 Liabilities Incurred: Accounts Payable—com- position agreement to accept 75¢ on the dollar in settlement of accounts payable..... 15,000
Liabilities Not Liquidated: Accounts Payable..... 11,000	Supplementary Credits: Composition Gain..... 5,000

Old and new accounts.—If the receiver continues operations, any liabilities which he incurs should be kept entirely separate from the old liabilities, because of the prior rights

which the receiver's creditors enjoy. The two classes may be designated as old accounts payable, and receiver's accounts payable or receiver's certificates.

Accounts receivable should be similarly separated, not because of any difference in the claims against the two classes of debtors, but because, with respect to old accounts receivable, the receiver is responsible only for diligence in collection, whereas, with respect to new accounts, he is responsible also for the exercise of good judgment in granting credits.

Continued operations.—When operations are continued by a receiver, the realization and liquidation account is more complicated, because of the necessity of showing operating transactions. However, the “journalizing” procedure can still be used effectively in the preparation of the statements. The statements on pages 168 and 169 are based on the illustration, in the preceding chapter, of the operations of F. C. White, as receiver for the *C* Company. Letters have again been inserted in the statements for reference purposes. The following details should be traced to the statements:

- (a) The assets, liabilities, and net worth as of June 30, 1934, the beginning of the receivership, are entered in the statement as follows:
 - Debits: Cash—in the cash account.
 - Other assets—Under Assets To Be Realized.
 - Credits: Liabilities—under Liabilities To Be Liquidated.
 - Capital Stock and Deficit—in the memorandum Capital account.
- (b) Purchases on account, \$120,000.00:
 - Debit: Supplementary Charges—Purchases.
 - Credit: Liabilities Assumed—Accounts Payable.
- (c) Sales on account, \$200,000.00:
 - Debit: Assets Acquired—Accounts Receivable.
 - Credit: Supplementary Credits—Sales.
- (d) Cash collections of \$47,500.00 were obtained on old accounts receivable; the remaining accounts were uncollectible:
 - Debit: Cash.
 - Credit: Assets Realized.
- (e) The notes receivable, \$15,000.00, were collected in full:
 - Debit: Cash.
 - Credit: Assets Realized.

(Continued on page 170.)

THE C COMPANY—IN RECEIVERSHIP

F. C. WHITE—RECEIVER

Realization and Liquidation Account

Assets To Be Realized:		
(a) Accounts Receivable—Old	\$50,000	
(a) Less Reserve for Bad Debts	1,500	\$ 48,500
(a) Notes Receivable—Old	15,000	
(a) Inventory	60,000	
(a) Marketable Securities	7,500	
(a) Land	10,000	
(a) Building	\$80,000	
(a) Less Reserve for Depreciation	15,000	65,000
(a) Furniture and Fixtures	\$10,000	
(a) Less Reserve for Depreciation	3,000	7,000
(a) Unexpired Insurance		900
		<u>\$213,900</u>
Assets Acquired:		
(c) Accounts Receivable—New		200,000
Supplementary Charges:		
(b) Purchases	\$120,000	
(g) Discount on Sales	2,300	
(k) Mortgage Interest—June 30, 1934 to June 30, 1935		2,950
(n) Salaries and Wages	17,000	
(n) Freight In	350	
(n) Delivery Expense	1,000	
(n) Taxes	1,200	
(n) General Expense	7,500	152,300
		<u>\$ 47,500</u>
Liabilities Liquidated:		
(j) Accounts Payable—Old	\$ 95,000	
(j) Notes Payable—Old	25,000	
(j) Mortgage Interest Accrued—June 30, 1934	500	
(j) Mortgage Installment	5,000	
(j) Mortgage Interest—June 30, 1934 to April 30, 1935	2,500	
(m) Accounts Payable—Receiver's Purchases	75,000	203,000
Liabilities Not Liquidated:		
Accounts Payable	\$ 45,000	
Mortgage Payable	45,000	
Accrued Interest on Mortgage	450	90,450
		<u>5,420</u>
Net Profit on Realisation		<u>\$865,070</u>

\$865,070

THE C COMPANY—IN RECEIVERSHIP
F. C. WHITE—RECEIVER

Cash Account

	July 1, 1934 to June 30, 1935	
(a) Balance—June 30, 1934.....	\$ 1,800	(j) Accounts Payable—Old..... \$ 95,000
(d) Accounts Receivable—Old.....	47,500	(j) Notes Payable—Old..... 25,000
(e) Notes Receivable.....	15,000	(j) Mortgage Installment..... 5,000
(f) Interest on Notes Receivable.....	300	(j) Mortgage Interest Accrued June 30, 1934..... 2,500
(g) Accounts Receivable—New.....	157,700	(l) Mortgage Interest—June 30, 1934 to April 30, 1935..... 73,600
(h) Interest on Securities.....	120	(m) Accounts Payable—New..... 17,000
(i) Marketable Securities.....	7,350	(n) Salaries and Wages..... 350
		(n) Freight In..... 1,000
		(n) Delivery Expense..... 1,200
		(n) Taxes..... 7,500
		(n) General Expense..... 1,120
		Balance, June 30, 1935.....
	<u>\$229,770</u>	<u>\$55,420.00</u>

Memorandum Capital Account

(a) Deficit—June 30, 1934.....	\$ 4,800.00	(a) Capital Stock.....	\$50,000.00
Net Worth—June 30, 1935.....	50,620.00	Net Profit.....	5,420.00
	<u>\$55,420.00</u>		<u>\$55,420.00</u>

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- (f) Interest in the amount of \$300.00 was collected on the notes:
Debit: Cash.
Credit: Supplementary Credits—Interest.
- (g) New accounts receivable amounting to \$160,000.00 were settled by cash collections of \$157,700.00, and the allowance of cash discounts of \$2,300.00:
Debits: Cash, \$157,700.00.
Supplementary Charges—Discount on Sales, \$2,300.00.
Credit: Assets Realized—Accounts Receivable, \$160,000.00.
- (h) Interest of \$120.00 was collected on the marketable securities:
Debit: Cash.
Credit: Supplementary Credits.
- (i) The marketable securities were sold for \$7,350.00.
Debit: Cash.
Credit: Assets Realized.
- (j) Prior liabilities were paid as follows: accounts payable, \$95,000.00; notes payable, \$25,000.00; mortgage installment, \$5,000.00; mortgage interest accrued to June 30, 1934, \$500.00:
Debit: Liabilities Liquidated.
Credit: Cash.
- (k) The mortgage interest accrued from June 30, 1934 to June 30, 1935, was \$2,950.00:
Debit: Supplementary Charges.
Credit: Liabilities Assumed.
- (l) The receiver paid the accrued interest from June 30, 1934 to April 30, 1935, in the amount of \$2,500.00.
Debit: Liabilities Liquidated.
Credit: Cash.
- (m) Receiver's accounts payable for merchandise purchases were settled in the amount of \$75,000.00 as follows: cash payment, \$73,600.00; cash discounts taken, \$1,400.00:
Debit: Liabilities Liquidated—Accounts Payable, \$75,000.00.
Credits: Cash, \$73,600.00.
Supplementary Credits—Discount on Purchases, \$1,400.00.
- (n) The receiver paid expenses, as detailed in the statements:
Debit: Supplementary Charges.
Credit: Cash.

The assets as of June 30, 1935 (after providing for depreciation of the building and of the furniture and fixtures and for losses on bad debts, and after writing off the insurance premiums expired during the year) were next entered under Assets Not Realized; the liabilities at the end of the period were entered under Liabilities Not Liquidated; and the statement was balanced by entering the net profit for the year. This net profit should also be entered in the memorandum Capital account to determine whether the resulting net worth will balance the net assets.

In addition to the realization and liquidation account and the cash account, the receiver should prepare a profit and loss statement similar to the one on page 156 of the preceding chapter, and a balance sheet similar to the one on page 155 of the preceding chapter.

CHAPTER 41

STATEMENT OF REALIZATION, LIQUIDATION, AND OPERATIONS

Purpose.—The realization and liquidation account illustrated in the preceding chapter is the traditional form for the presentation of data with respect to realization and liquidation, but it is somewhat confusing and is not admirably adapted to its purpose. It is believed that the statement illustrated in this chapter presents the data more clearly, and hence is more satisfactory.

First illustration.—The statement on page 174 is based on the same facts as those used in the first illustration in the preceding chapter. Attention is directed to the following matters:

The financial condition at the beginning of the period is shown in the first column; the financial condition at the end of the period is shown in the last column.

The cash receipts and disbursements are detailed in the two Cash columns. After these two columns are footed, their totals are entered in the cash summary at the top of the statement, to determine the cash balance at the end of the period.

The changes in the other assets are fully described. For example, starting with merchandise valued at \$8,000.00, the trustee made purchases of \$500.00, received \$5,500.00 as proceeds of sales, lost \$3,000.00 on sales, and had no merchandise at the end of the period.

The changes in each liability are similarly described. Starting with accounts payable of \$28,000.00, the trustee incurred \$500.00 of additional liabilities for purchases, made payments of \$11,000.00, and had \$17,500.00 of unpaid accounts at the end of the period. The Net Worth section shows the net worth at the beginning of the period, the net loss for the period (as a

(First Illustration)

JAMES BUTLER
F. S. MONTGOMERY—TRUSTEE
Statement of Realization, Liquidation, and Operations
June 16, 1934 to August 31, 1934

	Balances, June 16, 1934	MISCELLANEOUS		CASH		PROFIT AND LOSS		Balances, August 31, 1934
		Charges	Credits	Receipts	Payments	Charges	Credits	
Assets:								
Cash:								
Balance, June 16, 1934	\$ 700							
Total Receipts	12,010							
Total	\$12,710							
Total Payments	11,200							
Balance, August 31, 1934	\$ 1,510							\$ 1,510
Merchandise	8,000	\$ 500						
Purchases				\$ 5,500				
Proceeds of Sales								
Loss on Sales								
Accounts Receivable	7,000			4,500		\$ 3,000		
Collections								
Balance	3,000			2,000		1,000		2,500
Notes Receivable								
Collections								
Losses								
Interest on Notes Receivable								
Land and Building	14,500			10			\$ 10	
Total Assets	\$33,200							14,500
								\$18,510
LIABILITIES:								
Accounts Payable	\$28,000							
Incurred for Purchases								
Paid					\$11,000			\$17,500
Unpaid					200			\$17,500
Expenses								
Total Liabilities	\$28,000							
Net Worth:								
James Butler, Capital	\$ 5,200							
Net Loss								
Balance, August 31, 1934		\$ 500	\$ 500	\$12,010	\$11,200	\$ 4,200	4,190	\$ 1,010
								\$ 4,200

balancing figure in the Profit and Loss columns), and the net worth at the end of the period.

The Miscellaneous columns include all items not classified in the Cash and the Profit and Loss columns. The debits and credits in these columns are equal.

The Profit and Loss columns show the details accounting for the net loss of \$4,190.00. Glancing down these columns, we find that \$3,000.00 was lost on sales of merchandise, and \$1,000.00 on uncollectible notes receivable; that \$200.00 of expenses were incurred; and that \$10.00 of interest was earned on notes receivable.

Second illustration.—The statement on pages 176 and 177 is based on the same facts as the second illustration in the preceding chapter. It should not be necessary to refer to the preceding chapter to determine the facts, as the statement in this chapter is self-explanatory.

Attention is directed to the method of introducing income items into the Asset section of the statement. It will be noted that the interest on notes receivable and on securities is shown immediately below the notes and the securities. Income should be shown in the Asset section even if there were no accrued items to appear in the Balance columns at either the beginning or end of the period.

Attention is also directed to the method of introducing expense items into the Liability section of the statement. Interest on the mortgage is shown immediately below the mortgage. The absence of balances on the lines for Salaries and Wages, Freight In, Delivery Expense, Taxes, and General Expense shows that there were no unpaid liabilities for such expenses at either the beginning or end of the period.

Third illustration.—The statement on pages 178, 179, and 180 is based on assumed facts not used in any previous illustration. It is presented without any preliminary listing of the facts, as they are shown clearly by the statement itself.

In the solution of problems which require the preparation of statements of this nature, space should be left after each asset and liability sufficient to provide for the requirements of the problem.

(Second Illustration)

THE C COMPANY—IN RECEIVERSHIP

F. S. WHITE—RECEIVER

Statement of Realization, Liquidation, and Operations
Year Ended June 30, 1935

	Balances, June 30, 1934	MISCELLANEOUS		CASH		PROFIT AND LOSS		Balances, June 30, 1935
		Charges	Credits	Receipts	Payments	Charges	Credits	
Assets:								
Cash:								
Balance, June 30, 1934.....	\$ 1,800							
Total Receipts.....								
Total.....	\$ 1,800							
Total Payments.....	\$ 229,770							
Total.....	228,650							
Balance, June 30, 1935.....	\$ 1,120							\$ 1,120
Accounts Receivable—Old.....	50,000							
Collections.....			\$ 1,500					
Losses charged to the Reserve.....				\$ 47,500				
Losses charged to Profit and Loss.....						\$ 1,000		
Reserve for Bad Debts.....	1,500*							
Charges for Losses.....			\$ 1,500					
Accounts Receivable—New—from Sales.....				157,700		2,300	\$200,000	40,000
Collections and Cash Discounts.....						1,200		1,200*
Balance Uncollected.....							300	
Reserve for Bad Debts—for New Accounts.....								
Notes Receivable—Old.....	15,000			15,000				
Interest on Notes Receivable.....	60,000			300				
Merchandise.....								
Purchases.....					120,000			
Cost of Goods Sold.....								
Inventory, June 30, 1935.....	7,500					157,000		23,000
Marketable Securities.....								
Proceeds of Sale, and Loss.....								
Interest on Securities.....								
Land.....	10,000			7,350		150		10,000
Building.....	80,000			120				80,000
Reserve for Depreciation—Building.....	15,000*							
Depreciation for the Year.....						3,200		
Reserve, June 30, 1935.....	10,000							18,200*
Furniture and Fixtures.....								10,000

Interest on Notes Receivable:									
Collected.....									350
Accrued.....									250
Finished Goods.....	50,000								
Decrease during Year.....									
Balance.....									12,000
Goods in Process.....	7,700								
Increase during Year.....									
Balance.....									2,000
Raw Materials.....	35,000								
Purchases.....		95,000							
Used.....									
Balance.....									105,000
Land.....	20,000								
Buildings.....	60,000								
Reserve for Depreciation.....	9,800*								
Depreciation for the Year.....									
Balance.....									1,800
Building Rental Income.....									
Machinery.....	80,000								
Fully Depreciated—Written Off.....									
Balance.....			6,000						\$ 8,500
Reserve for Depreciation.....	25,000*								
Charge for Fully Depreciated Asset.....					6,000				
Depreciation for the Year.....									4,000
Balance.....									
Prepaid Insurance.....	850								
Payments.....									2,300
Amount Expired.....									
Unexpired.....									1,600
Advertising.....	2,500								
Payments.....									3,000
Charged to Expense.....									
Total Assets.....	\$316,750								5,500
LIABILITIES:									
Bonds Payable.....	\$ 50,000								
Bonds Retired at a Discount.....									150
Balance.....									\$ 45,000
Notes Payable—Old.....	35,000								
Interest on Notes Payable.....	270								
Accrued during the Year.....									150
Accounts Payable—Old.....	105,000								
Payment and Discounts Taken.....									103,850
Accounts Payable—New—for Purchases.....									
Payments and Discounts Taken.....									95,000
Notes given in Settlement.....									
Balance.....		25,000							800
Forward.....	\$190,270	\$165,200	\$140,200	\$354,770	\$197,920	\$137,000	\$306,950		24,200
									\$ 69,200

Statement of Realization, Liquidation, and Operations—(Continued)

	MISCELLANEOUS		CASH		PROFIT AND LOSS		Balances, December 31, 1934
	Charges	Credits	Receipts	Payments	Charges	Credits	
Forward	\$190,270	\$140,200	\$384,770	\$197,920	\$137,000	\$306,950	\$ 69,200
Notes Payable—Given on Account		25,000					25,000
Accrued Interest on Notes Payable							120
Direct Labor	900			75,000	75,200		1,100
Indirect Labor				6,500	6,500		
Manufacturing Expenses				18,300	18,300		
Salesmen's Salaries				35,000	35,800		
Office Salaries	600			8,100	7,500		800
General Expenses				3,600	3,600		
Receiver's Charges				5,000	5,000		
Total Liabilities	\$191,770						\$ 96,220
NET WORTH:							
James Martin, Capital	\$ 61,900						
Net Profit—One half					8,965		
Drawings				2,500			
Balance, December 31, 1934	63,080						\$ 68,365
FRANK BAUGMAN CAPITAL							
Net Profit—One half					8,965		
Drawings				2,500			
Balance, December 31, 1934	\$124,980	\$165,200	\$354,770	\$354,420	\$306,950	\$306,950	69,545
Total Net Worth		\$165,200					\$137,910

CHAPTER 42

HOME OFFICE AND BRANCH ACCOUNTING—COMBINED STATEMENTS

Agencies and branches.—Although agencies and branches differ in several particulars, the two words are often used indiscriminately. Agencies and branches both are means of projecting the sales organization into territory at a distance from the home office, and setting up a permanent sales establishment in the buyers' territory; but aside from this common feature, the agency and the branch differ very widely in organization, management, and control. The points of difference may be summarized as follows:

<u>Agency</u>	<u>Branch</u>
Carries a line of samples for inspection, but does not carry a full stock for making deliveries to customers. Orders are sent to the home office and deliveries are made by the home office.	Carries a stock of merchandise, most of which is usually obtained from the home office, but part of which may be purchased from outsiders. Deliveries are made from the branch stock.
Credits passed on by the home office; accounts receivable carried on the home office books; collections made by the home office.	Credits passed on by the branch; accounts receivable carried on the branch books; collections made by the branch.
Working fund for agency expenses provided by the home office, and replenished by the home office when exhausted. No other cash handled by the agency.	Receipts from sales and collections deposited in local bank to the credit of the branch; checks for expenses drawn by the branch manager.

It is evident from this summary that an agency exercises about the same functions as a traveling salesman, while the branch exercises most of the functions of an independent business, subject only to the supervision and control of the home office.

The foregoing summary is descriptive of the true agency and the true branch, but extensions may be made whereby the agency is vested with some of the powers of a branch. For instance, the agency may carry a stock of merchandise and make deliveries, although credits are passed on by the home office, and the accounts receivable are carried on the home office books.

On the other hand, some restrictions may be placed on a branch. For instance, although the branch may be allowed to pass on its own credits, the accounts may be carried on the home office books. A very common restriction has to do with cash. The branch manager may be required to deposit all receipts from sales and all collections in a bank account in the name of the home office, subject to check by the home office only; a working fund for expenses is then provided from the home office by a deposit in a separate bank account which may be drawn against by the branch manager, and which is replenished by another check from the home office.

Thus it appears that while there are true agencies and true branches, other establishments exist having some of the characteristics of both—agencies exercising some of the functions of branches, and branches subject to some of the restrictions which apply to agencies. It is neither possible nor necessary to consider here all of the variations from the true agency and the true branch. The accounting methods used by the typical agency and the typical branch will be illustrated, since it is understood that, if an agency exercises some of the functions of a branch, or if a branch is subject to some restrictions which usually apply only to agencies, their accounting systems will necessarily be modified to suit the conditions.

Agency accounts.—An agency does not need to keep a double entry system of accounts. All that is necessary is a cash book in which to record money received from the home office for its working fund, and the disbursements made

therefrom for expenses. The disbursement record is usually kept in duplicate. When the working fund runs low and a replenishing check is desired, one copy of the disbursement sheet is sent to the home office, together with the vouchers, as evidence of the nature and propriety of the disbursements, and the other copy is retained by the agency. A memorandum record of sales may be made, but no postings are made from it, and no ledger is kept at the agency.

The home office, on the other hand, must keep its records in such a manner as to show:

- (1) The merchandise sent to the agency for sample purposes.
- (2) The cash sent to the agency for the establishment of the working fund.
- (3) The sales made by the agency.
- (4) The cost of goods sold by the agency.
- (5) The expenses of the agency.
- (6) The profits of the agency.

The following illustration shows how these records are kept on the home office books; it is understood that the agency keeps only a cash book.

- (1) Samples to the value of \$1,000.00 sent to the agency:

Agency Samples.....	1,000.00	
Purchases.....		1,000.00

- (2) Working fund of \$500.00 established:

Agency Working Fund.....	500.00	
Cash.....		500.00

- (3) Sales of \$10,000.00 reported by the agency and delivered by the home office:

Accounts Receivable.....	10,000.00	
Agency Sales.....		10,000.00

Collections of accounts receivable arising from agency sales are recorded in the usual way.

- (4) Cost of agency sales, \$7,000.00:

Cost of Agency Sales.....	7,000.00	
Purchases.....		7,000.00

This entry may be made at the end of the period for the total cost of sales, but a memorandum record must be kept during the period when sales orders are filled. This memorandum record will furnish the information for the above entry at the end of the period.

- (5) When the agency reports its cash disbursements for expenses, the home office issues a check to the agency to replenish its working fund, and makes an entry similar to the following:

Agency Expenses (detailed as desired)	1,400.00	
Cash.....		1,400.00

- (6) Entry to close the accounts showing agency profit:

Agency Sales.....	10,000.00	
Cost of Agency Sales....		7,000.00
Agency Expenses.....		1,400.00
Profit and Loss....		1,600.00

If it is not desired to keep the records in such a way as to show the profit of the agency as a separate amount, the agency sales may be credited to the regular Sales account, entry (4) for cost of sales may be omitted, and the expenses may be charged to the regular expense accounts.

Branch accounts.—The accounting for a branch is more complex. The branch keeps a complete set of books in which to record goods received from the home office and purchased from outsiders, sales, accounts receivable, accounts payable, and expenses. The ledger contains an account called Home Office Current, which is credited with everything received from the home office and charged with everything sent to the home office. The Home Office Current account is thus a proprietorship account, showing the investment made by the home office in the branch. When the branch closes its books, a net profit is transferred from Profit and Loss to the Home Office Current account, as an increase in the investment, while a net loss is closed to the debit of the Home Office Current account.

The methods used by the home office depend, to some extent, on the price at which goods are billed to the branch. Three illustrations are therefore given, dealing with the three typical methods of billing:

- (1) Goods billed to the branch at cost.
This is the usual method and the simplest one.
- (2) Goods billed to the branch at an arbitrary value between cost and selling price.
This method is sometimes used in order to keep the branch manager in ignorance of the cost of goods sold and hence of the profits of the branch.
- (3) Goods billed to the branch at selling price.
This method is based on the theory that if the branch charges its merchandise accounts with the selling price of goods received and credits its merchandise accounts with sales at the same price, the net balance of the merchandise accounts on the books of the branch should represent the selling price of the goods on hand. In other words, this method is supposed to provide a perpetual inventory of branch merchandise at selling price, and thus furnish a check on the goods, which will prevent or detect carelessness or fraud. The method works well unless frequent changes are made in selling prices; if selling prices fluctuate frequently, it is necessary to make so many adjustments that the work involved usually outweighs the advantages.

First illustration: SHIPMENTS AT COST.—Assume the following transactions:

- (1) Cash sent to the branch, \$500.00.
- (2) Merchandise sent to the branch, \$5,000.00.
- (3) Merchandise purchased by the branch from outsiders on account, \$1,000.00.
- (4) Sales by branch:

Cash.....	\$2,000.00.
On account.....	\$5,000.00.
- (5) Collections from accounts receivable, \$4,200.00.
- (6) Payments to accounts payable, \$750.00.
- (7) Expenses paid, \$1,200.00.
- (8) Cash sent to home office, \$4,000.00.

The following journal entries show the accounts debited and credited by the home office and the branch:

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<u>Branch Books</u>		<u>Home Office Books</u>	
(1) Cash.....	500	Branch Current.....	500
Home Office Current.....	500	Cash.....	500
(2) Mdse. from H. O....	5,000	Branch Current	5,000
Home Office Current.....	5,000	Shipments to Branch	5,000
(3) Purchases.....	1,000	(to be closed to	
Accounts Pay..	1,000	Purchases)	
(4) Cash.....	2,000		
Accounts Receivable	5,000		
Sales....	7,000		
(5) Cash.....	4,200		
Accounts Rec..	4,200		
(6) Accounts Payable ..	750		
Cash.....	750		
(7) Expenses..	1,200		
Cash.....	1,200		
(8) H. O. Current.....	4,000	Cash.....	4,000
Cash.....	4,000	Branch Current...	4,000

The branch is now ready to close its books. Assuming that its inventory is \$1,500.00, the closing entries on the branch books are:

Profit and Loss.....	7,200.00		
Merchandise from Home Office		5,000.00	
Purchases.....		1,000.00	
Expenses.....		1,200.00	
Inventory.....	1,500.00		
Sales.....		7,000.00	
Profit and Loss.....		8,500.00	
Profit and Loss.....	1,300.00		
Home Office Current.....		1,300.00	

After closing its books, the branch draws off the following balance sheet:

Branch Balance Sheet

Cash.....	\$ 750.00	Accounts Payable.....	\$ 250.00
Accounts Receivable....	800.00	Home Office Current.....	2,800.00
Inventory.....	1,500.00		
	<u>\$3,050.00</u>		<u>\$3,050.00</u>

The home office takes up the profit by the following entry:

Branch Current Account.....	1,300.00		
Branch Profit and Loss.....		1,300.00	

The Branch Current account on the home office books now appears as follows:

Branch Current			
Cash (sent to branch).....	500.00	Cash (received from branch) ..	4,000.00
Merchandise (sent to branch).....	5,000 00	Balance..	2,800.00
Net Profit of Branch.....	1,300 00		
	<u>6,800 00</u>		<u>6,800 00</u>
Balance—down.....	2,800.00		

Combined statements.—At the end of the period, statements should be made combining the profit and loss statements of the branch and the home office, and the balance sheets of the branch and the home office. Using assumed figures for the home office, these statements are illustrated below:

THE X Y COMPANY						
Profit and Loss Statement						
For the Year Ended December 31, 1933						
	Branch		Home Office		Total	
Sales.....		\$7,000		\$18,000		\$25,000
Less Cost of Goods Sold:						
Inventory—January 1.			\$ 4,000		\$ 4,000	
Purchases and Shipments from Home Office.....	\$6,000		13,000		19,000	
Total.....	\$6,000		\$17,000		\$23,000	
Inventory—December 31.....	1,500	4,500	5,000	12,000	6,500	16,500
Gross Profit on Sales.....		\$2,500		\$ 6,000		\$ 8,500
Less Expenses.....		1,200		2,700		3,900
Net Profit.....		<u>\$1,300</u>		<u>\$ 3,300</u>		<u>\$ 4,600</u>

THE X Y COMPANY			
Balance Sheet			
December 31, 1933			
Assets		Liabilities	
Cash.....	\$ 3,950.00	Accounts Payable.....	1,650.00
Accounts Receivable.....	3,700.00	Capital Stock.....	\$ 7,500.00
Inventory.....	6,500.00	Surplus.....	5,000.00
	<u>\$14,150.00</u>		<u>\$14,150.00</u>

This balance sheet was prepared from the following working papers, in which similar assets and liabilities are combined, and the reciprocal current accounts are eliminated.

**Combined Balance Sheet Working Papers
December 31, 1933**

	<u>Home Office</u>	<u>Branch</u>	<u>Elimina- tions</u>	<u>Balance Sheet</u>
Assets				
Cash.....	3,200.00	750.00		3,950.00
Accounts Receivable....	2,900.00	800.00		3,700.00
Inventory.....	5,000.00	1,500.00		6,500.00
Branch Current.....	2,800.00		2,800.00	
	<u>13,900.00</u>	<u>3,050.00</u>	<u>2,800.00</u>	<u>14,150.00</u>
Liabilities				
Accounts Payable.....	1,400.00	250.00		1,650.00
Home Office Current.....		2,800.00	2,800.00	
Capital Stock.....	7,500.00			7,500.00
Surplus.....	5,000.00			5,000.00
	<u>13,900.00</u>	<u>3,050.00</u>	<u>2,800.00</u>	<u>14,150.00</u>

Second illustration: SHIPMENTS AT ARBITRARY VALUE.—In this illustration it is assumed that the home office bills all goods to the branch at 10% above cost, in order to keep the branch manager uninformed concerning the true profits of the branch. The following transactions are recorded:

- (1) Cash sent to branch, \$500.00.
- (2) Merchandise sent to branch, cost \$5,000.00, billed at \$5,500.00.
- (3) Branch sales (all for cash) \$6,000.00.
- (4) Expenses paid, \$1,200.00.
- (5) Cash sent to home office, \$4,000.00.

The branch inventory at the end of the period is \$1,650.00, at billed prices.

<u>Branch Books</u>		<u>Home Office Books</u>	
(1) Cash.....	500	Branch Current.....	500
Home Office		Cash.....	500
Current.....	500		
(2) Mdse. from H. O. . . .	5,500	Branch Current.....	5,500
Home Office		Shipments to	
Current.....	5,500	Branch.....	5,500
(3) Cash.....	6,000		
Sales.....	6,000		
(4) Expense.....	1,200		
Cash.....	1,200		
(5) Home Office Current	4,000	Cash.....	4,000
Cash.....	4,000	Branch Current...	4,000

		<u>Closing Entries</u>			
Profit and Loss.....	6,700				
Mdse. from H. O		5,500			
Expense.....		1,200			
Inventory.....	1,650				
Sales.....	6,000				
Profit and Loss		7,650			
Profit and Loss...	950		Branch Current	950	
H. O. Current...		950	Branch Profit & Loss.....		950
			Shipments to Branch..	5,500	
			Purchases.....		5,000
			Branch Profit & Loss.....		350
			Reserve for Unrealized Profit in Branch Inventory.....		150

These illustrative entries show that the practice of billing at an arbitrary figure above cost does not affect the accounting methods or the books of the branch in any way except that the Profit and Loss account does not show the true profit of the branch.

The home office books are kept in the same manner as in the first illustration, the only difference being in the entry closing out the Shipments to Branch account. The Purchases account is credited with the cost of the goods shipped to the branch, \$5,000.00; the Branch Profit and Loss account is credited with the 10% profit realized by the sale of goods costing \$3,500.00; and a reserve is credited with \$150.00, the 10% unrealized profit on the goods in the branch inventory, which cost \$1,500.00 and which are inventoried by the branch at the billed price of \$1,650.00.

This reserve is deducted from the inventory, as shown in the following working papers.

Combined Balance Sheet Working Papers				
	<u>Home Office</u>	<u>Branch</u>	<u>Eliminations</u>	<u>Balance Sheet</u>
Assets				
Cash.....	3,500.00	1,300.00		4,800.00
Accounts Receivable.....	2,950.00			2,950.00
Inventory.....	6,800.00	1,650.00	150.00	8,300.00
Branch Current.....	2,950.00		2,950.00	
	<u>16,200.00</u>	<u>2,950.00</u>	<u>3,100.00</u>	<u>16,050.00</u>

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	Home Office	Branch	Elimina- tions	Balance Sheet
Liabilities				
Accounts Payable.....	2,000.00			2,000.00
Reserve for Unrealized Profit in Inventory.....	150.00		150.00	
Home Office Current..		2,950.00	2,950.00	
Capital Stock.....	10,000.00			10,000.00
Surplus.....	4,050.00			4,050.00
	16,200.00	2,950.00	3,100.00	16,050.00

Third illustration: SHIPMENTS AT SELLING PRICE.—In this illustration it is assumed that the home office bills all goods to the branch at selling price, to keep the branch manager uninformed as to the profits of the branch, and also to maintain a control over the branch merchandise. This control is based on the fact that the debits to Merchandise from Home Office, on the branch books, minus the credits to Sales, on the branch books, should equal the inventory at the branch at selling prices. The following transactions are recorded:

- (1) Cash sent to branch, \$500.00.
- (2) Merchandise sent to branch, cost \$5,000.00, selling price \$7,500.00. (While the total selling price is 150% of the cost, it must not be assumed that this rate applies to each commodity, as there may be different rates of mark-up.)
- (3) Branch sales, all for cash, \$6,000.00.
- (4) Expenses paid, \$1,200.00.
- (5) Cash sent to home office, \$4,000.00.

The inventory at the branch at the end of the period is valued at selling prices totaling \$1,400.00. Therefore goods marked to sell at \$100.00 are unaccounted for. (\$7,500.00 shipments minus \$6,000.00 sales, should leave an inventory of \$1,500.00 instead of \$1,400.00.)

	Branch Books		Home Office Books
(1) Cash.....	500	Branch Current.....	500
Home Office Current.....	500	Cash.....	500
(2) Mdse. from H. O.	7,500	Branch Current.....	7,500
H. O. Current..	7,500	Shipments to Branch.....	7,500

A memorandum record of the cost of the goods should be kept in the Shipments account, the credit side of which would appear as follows.

Shipments to Branch		
	Cost	Selling Price
Date.....	5,000.00	7,500.00

<u>Branch Books</u>		<u>Home Office Books</u>	
(3) Cash.....	6,000		
Sales.....	6,000		
(4) Expense.....	1,200		
Cash.....	1,200		
(5) H. O. Current.....	4,000	Cash.....	4,000
Cash.....	4,000	Branch Current...	4,000

When the branch closes its books, there is no object in setting up a Profit and Loss account, because no profit can possibly be shown. The following entry is sufficient to effect the closing:

Sales... ..	6,000		
Inventory.	1,400		
H. O. Current... ..	1,300		
Mdse. from H. O..	7,500		
Expense.....	1,200		

The charge to the Home Office Current account is the sum of the expenses and the \$100.00 merchandise shortage.

The home office takes up the apparent, or book, loss shown by the branch books, as follows:

Branch Profit & Loss...	1,300		
Branch Current...		1,300	

The branch inventory is sent to the home office, and all items are repriced at cost (or market, if lower than cost). Assuming that the cost of the inventory (selling price \$1,400.00) is found to be \$975.00, a reserve must be set up for the \$425.00 unrealized profit in the inventory, and the remaining profit of \$2,075.00 (\$2,500.00 profit added to shipments minus \$425.00 unrealized profit) may be credited to Branch Profit and Loss, because it has been realized by branch sales.

Shipments to Branch...	7,500		
Purchases.....		5,000	
Reserve for Un- realized Profit in Branch Inventory			425
Branch Profit & Loss.....			2,075

The Branch Profit and Loss account on the home office books now stands:

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Credited with profits realized by branch sales.....	\$2,075.00
Debited with book loss, per branch books.....	<u>1,300.00</u>
Net credit, or branch profit.....	<u>\$ 775.00</u>

This is the true branch profit, as shown by the following profit and loss statement:

Branch Sales.....	\$6,000.00
Less Cost of Goods Sold:	
Shipments—at cost.....	\$5,000.00
Less Inventory—at cost.....	<u>975.00</u>
	4,025.00
Gross Profit on Sales.....	\$1,975.00
Less Expense.....	<u>1,200.00</u>
Net Profit.....	<u>\$ 775.00</u>

The reserve for unrealized profit in the branch inventory is deducted from the inventory in the working papers for the combined balance sheet, in the same manner as shown in the illustration on page 190.

Fixed assets.—The fixed assets of a branch are usually carried on the home office books. If this method is followed, a purchase of fixed assets by the home office for the branch is recorded on the home office books by a debit to Branch Furniture and Fixtures (or other fixed asset account) and a credit to Cash. No entries will appear on the branch books. If the fixed assets are purchased by the branch, the entry on the branch books debits the Home Office Current account and credits Cash. The branch will report the purchase to the home office, which will debit Branch Furniture and Fixtures (or other fixed asset account) and credit Branch Current account.

Branch expenses on home office books.—Some expenses applicable to the branch operations may appear on the home office books instead of on the branch books. For instance, if the fixed assets are carried on the home office books, the depreciation will be provided on these books. After taking up the profit as shown by the branch, the home office should make an entry on its books debiting Branch Profit and Loss and crediting the Reserve for Depreciation. If any of the home office expenses are to be apportioned in part to the branch, entries may be made debiting the Branch Profit and Loss account and crediting the expense accounts. The bal-

ance of the Branch Profit and Loss account will then represent the net profit of the branch, and this balance will be transferred to the general Profit and Loss account.

Reconciliation of reciprocal accounts.—The Branch Current account on the home office books, and the Home Office Current account on the branch books, are supposed to be reciprocal, but in actual practice this condition rarely exists, because entries made by the home office for remittances of cash and shipments of merchandise are not taken up on the branch books until some time later, when the cash and merchandise are received; and because entries on the branch books for cash remitted to the home office may not be taken up by the home office for several days, while the cash is in transit.

At closing time, therefore, it is necessary to make adjustments to bring the two current accounts into agreement. Any shipments made by the home office and not received by the branch at the closing date, should be taken up on the branch books by a debit to Merchandise in Transit and a credit to Home Office Current. This merchandise in transit should be included in the inventory. Any remittances made by the branch and not received by the home office at the closing date, should be taken up on the home office books by debiting Cash in Transit and crediting the Branch Current account. Other necessary adjustments should be made in a similar manner.

Interbranch transfers.—If merchandise is shipped from one branch to another, or if other assets are transferred between branches, the branch parting with the asset should debit the Home Office Current account and credit the asset. The branch receiving it should debit the asset and credit its Home Office Current account. The home office should debit the current account of the branch receiving the asset, and credit the current account of the branch parting with the asset. No branch should carry an account with any other branch; all interbranch transfers should be cleared through the home office current accounts.

Freight.—Freight on goods received by the branch can properly be included in the branch inventory, on the basis

of the same principles which apply to freight in. But if goods are shipped from one branch to another, the branch receiving the goods should include in the inventory valuation only such an amount of freight as would have been paid if the goods had been shipped directly from the home office. Any excess freight should be charged off as an expense.

To illustrate, assume that \$500.00 worth of goods are shipped from the home office to Branch A at a freight cost of \$25.00. These goods are reshipped by Branch A to Branch B at an additional freight cost of \$20.00, which is paid by Branch A. If the goods had been shipped from the home office to Branch B, the freight cost would have been \$30.00. The entries on the various books should be:

For shipment to Branch A:

Home Office:	Branch A	525.00	
	Shipments to Branch A		500.00
	Cash		25.00
Branch A:	Merchandise from Home Office	500.00	
	Freight In	25.00	
	Home Office Current		525.00

For shipment from Branch A to Branch B:

Branch A:	Home Office Current	525.00	
	Merchandise from Home Office		500.00
	Freight In		25.00
	Home Office Current	20.00	
	Cash		20.00
Branch B:	Merchandise from Home Office	500.00	
	Freight In	30.00	
	Home Office Current		530.00
Home Office:	Shipments to Branch A	500.00	
	Shipments to Branch B		500.00
	Branch B Current	530.00	
	Interbranch Excess Freight	15.00	
	Branch A Current		545.00

CHAPTER 43

PARENT AND SUBSIDIARY ACCOUNTING— CONSOLIDATED BALANCE SHEETS AT DATE OF ACQUISITION

Investments in branches and subsidiaries.—Let us assume that Company *P* established an unincorporated branch, with an investment of \$10,000.00 in cash and \$20,000.00 in merchandise. The following combined balance sheet working papers were prepared immediately after the establishment of the branch:

COMPANY *P* AND BRANCH *S*
Combined Balance Sheet Working Papers
July 31, 1933

	Company <i>P</i>	Branch <i>S</i>	Elimina- tions	Combined Balance Sheet
Assets				
Cash.	25,000 00	10,000.00		35,000.00
Merchandise Inventory..	60,000 00	20,000.00		80,000.00
Accounts Receivable.....	35,000.00			35,000.00
Branch Current.....	30,000 00		30,000.00	
	150,000.00	30,000.00	30,000 00	150,000 00
Liabilities and Net Worth				
Accounts Payable.....	40,000.00			40,000.00
Home Office Current....		30,000.00	30,000.00	
Capital Stock.....	100,000.00			100,000.00
Surplus.....	10,000.00			10,000.00
	150,000.00	30,000.00	30,000 00	150,000 00

In these working papers, the balances of the two reciprocal Current accounts are eliminated because they represent mere interrelationships between the home office and the branch.

Let us now assume that Branch *S* was incorporated as a separate company on July 31, 1933, and issued \$30,000.00 of capital stock to Company *P* for the cash and merchandise received. Company *P* is a parent company, or holding company; Company *S* is a subsidiary.

Although the two companies are separate corporate entities, they constitute a single business organization, and a consolidated balance sheet should be prepared to show their

combined assets and liabilities. The working papers for the consolidation of the balance sheets of this parent company and its subsidiary are similar to those of a home office and branch, except for the change in the names of the reciprocal accounts.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
July 31, 1933

	Com- pany <i>P</i>	Com- pany <i>S</i>	Inter- company Elimina- tions	Consoli- dated Balance Sheet
Assets				
Cash.....	25,000	10,000		35,000
Merchandise Inventory.....	60,000	20,000		80,000
Accounts Receivable.....	35,000			35,000
Investment in Stock of Company <i>S</i>	30,000		30,000	
	150,000	30,000	30,000	150,000
Liabilities and Net Worth				
Accounts Payable.....	40,000			40,000
Capital Stock:				
Company <i>P</i>	100,000			100,000
Company <i>S</i>		30,000	30,000	
Surplus.....	10,000			10,000
	150,000	30,000	30,000	150,000

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
July 31, 1933

Assets		Liabilities and Net Worth	
Cash.....	\$ 35,000	Accounts Payable.....	\$ 40,000
Inventory.....	80,000	Net Worth:	
Accounts Receivable.....	35,000	Capital Stock..	\$100,000
		Surplus.....	10,000
	\$150,000		110,000
			\$150,000

Intercompany eliminations.—The elimination of intercompany accounts in the foregoing working papers may be expressed by the following rule:

- Elimination of reciprocals:
 - Subsidiary's Capital Stock account.
 - Parent company's Investment account.

Purposes of the consolidated balance sheet.—The consolidated balance sheet of a parent and subsidiary serves two purposes, namely:

First: The parent company and its subsidiary, although legally separate entities, constitute a single business organization. Each company's balance sheet shows its own assets and liabilities, but a consolidated balance sheet is required if it is desired to show the total assets and liabilities of the combined organization.

Second: A balance sheet of the parent company alone, showing the balance of the subsidiary stock investment account, does not provide a comprehensive picture of the parent company's financial condition. The value of the investment in the subsidiary stock is dependent upon the value of the assets and the amount of the liabilities of the subsidiary; the financial condition of the parent company is therefore more adequately presented by a consolidated balance sheet in which the underlying assets and liabilities are substituted for the subsidiary stock investment.

Subsidiary surplus or deficit.—Let us now assume that a company which has been in operation for some time has net assets of \$65,000.00, represented by capital stock of \$50,000.00 and surplus of \$15,000.00. Its stock is acquired by another corporation at book value, \$65,000.00. The reciprocal balances on the books of the two companies are:

On parent company's books:

Investment in Stock of Company <i>S</i> (debit).....	\$65,000.00
--	-------------

On subsidiary's books:

Capital Stock (credit)	\$50,000.00	
Surplus (credit).....	<u>15,000.00</u>	\$65,000.00

Obviously, the elimination of reciprocal balances will not be complete unless the subsidiary's surplus, as well as its capital stock, is eliminated.

Or let us assume that a company has net assets of \$45,000.00, represented by capital stock of \$60,000.00 and a deficit of \$15,000.00. Its stock is acquired by another corporation at book value, \$45,000.00. The reciprocal balances on the books of the two companies are:

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On parent company's books:

Investment in Stock of Company *S* (debit)..... \$45,000.00

On subsidiary's books:

Capital Stock (credit)..... \$60,000.00
 Less Deficit (debit)..... 15,000.00 \$45,000.00

Again it is obvious that the elimination of reciprocals will require the elimination of the subsidiary's deficit as well as its capital stock.

We must therefore modify our original rule for the elimination of intercompany balances by the addition of the words shown below in italics:

Elimination of reciprocals:

Subsidiary's Capital Stock *and Surplus or Deficit accounts.*

Parent company's Investment account.

Two illustrations are given involving a subsidiary surplus or deficit.

First illustration: SUBSIDIARY SURPLUS.—The following working papers show the elimination of a subsidiary's Capital Stock and Surplus accounts, which (together) are reciprocal to the Investment account:

COMPANY *P* AND SUBSIDIARY *S*
 Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	Com- pany <i>P</i>	Com- pany <i>S</i>	Elimi- nations	Consoli- dated Balance Sheet
Assets				
Investment in Stock of Company <i>S</i>	65,000		65,000	
Cash.....	20,000	70,000		90,000
	<u>85,000</u>	<u>70,000</u>	<u>65,000</u>	<u>90,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	5,000		15,000
Capital Stock:				
Company <i>P</i>	75,000			75,000
Company <i>S</i>		50,000	50,000	
Surplus:				
Company <i>S</i>		15,000	15,000	
	<u>85,000</u>	<u>70,000</u>	<u>65,000</u>	<u>90,000</u>

Second illustration: **SUBSIDIARY DEFICIT.**—The following working papers show the elimination of a subsidiary's Capital Stock and Deficit accounts, which (net) are reciprocal to the Investment account:

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S....	45,000		45,000	
Cash.	35,000	55,000		90,000
	<u>80,000</u>	<u>55,000</u>	<u>45,000</u>	<u>90,000</u>
Liabilities and Net Worth				
Accounts Payable	20,000	10,000		30,000
Capital Stock:				
Company P.	50,000			50,000
Company S.		60,000	60,000	
Surplus (Deficit*):				
Company P.	10,000			10,000
Company S.		15,000*	15,000*	
	<u>80,000</u>	<u>55,000</u>	<u>45,000</u>	<u>90,000</u>

Minority interest.—If the parent company acquires less than 100% of the stock of the subsidiary, it shares the ownership of the subsidiary with the outsiders whose stock it does not purchase. These outsiders are called the minority stockholders of the subsidiary. The Capital Stock and Surplus (or Deficit) accounts of the subsidiary then include two elements:

The holding company's percentage of the subsidiary stock and surplus (or deficit). These items are reciprocal to the parent company's Investment account, and should therefore be eliminated.

The minority stockholders' interest in the subsidiary stock and surplus (or deficit). These items are not reciprocal to any balances on the parent company's books, and are therefore carried to the consolidated balance sheet.

We must therefore again modify our original rule for the elimination of intercompany balances, by the addition of the words shown below in italics:

Elimination of reciprocals:

Subsidiary's Capital Stock and Surplus or Deficit accounts.

Eliminate reciprocal element—parent company's proportion.

Extend non-reciprocal element (minority interest) to Consolidated Balance Sheet column.

Parent company's Investment account.

Three illustrations are given involving a minority interest in the subsidiary.

First illustration: NO SUBSIDIARY SURPLUS OR DEFICIT.—In this illustration it is assumed that the subsidiary had a capital stock of \$50,000.00 and no surplus or deficit at the date when the parent company acquired 90% of its stock at book value, \$45,000.00.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	Com- pany P	Com- pany S	Elimi- na- tions	Consoli- dated Balance Sheet
Assets				
Cash.....	65,000	60,000		125,000
Investment in Stock of Company S.....	45,000		45,000	
	<u>110,000</u>	<u>60,000</u>	<u>45,000</u>	<u>125,000</u>
Liabilities and Net Worth				
Accounts Payable.....	20,000	10,000		30,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 90%.....			45,000	
Minority Interest—10%.....				5,000M
Surplus—Company P.....	15,000			15,000
	<u>110,000</u>	<u>60,000</u>	<u>45,000</u>	<u>125,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Assets		Liabilities and Net Worth	
Cash.....	\$125,000	Accounts Payable.....	\$ 30,000
		Minority Interest—Company S (10%).....	5,000
		Capital Stock.....	75,000
		Surplus.....	15,000
	<u>\$125,000</u>		<u>\$125,000</u>

Second illustration: SUBSIDIARY SURPLUS.—In this illustration it is assumed that the subsidiary had a capital stock of \$50,000.00 and a surplus of \$10,000.00, making a total net worth of \$60,000.00, at the date when the parent company acquired 90% of its stock at book value, \$54,000.00.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S.....	54,000		54,000	
Cash.....	46,000	75,000		121,000
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	15,000		25,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 90%...			45,000	
Minority Interest—10%.....				5,000M
Surplus:				
Company P.....	15,000			15,000S
Company S.....		10,000		
Eliminate Parent Company's 90%...			9,000	
Minority Interest—10%.....				1,000M
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Assets		Liabilities and Net Worth	
Cash.....	\$121,000	Accounts Payable.....	\$ 25,000
		Minority Interest in Com- pany S (10%):	
		Capital Stock... \$	5,000
		Surplus.....	1,000
		6,000	
		Capital:	
		Capital Stock... \$	75,000
		Surplus.....	15,000
		90,000	
	<u>\$121,000</u>		<u>\$121,000</u>

The minority interest may be shown in one amount, without detailing the capital stock and surplus, as shown in the illustration on the following page.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

(Date of Acquisition)

Assets		Liabilities and Net Worth	
Cash.....	\$121,000	Accounts Payable.....	\$ 25,000
		Minority Interest in Co. S (10%)	6,000
		Capital:	
		Capital Stock.....	\$75,000
		Surplus...	15,000
			90,000
	<u>\$121,000</u>		<u>90,000</u>
			<u>\$121,000</u>

Third illustration: **SUBSIDIARY DEFICIT.**—The subsidiary had a capital stock of \$50,000.00 and a deficit of \$10,000.00, or a net worth of \$40,000.00, at the date when the parent company acquired 90% of its stock at book value, \$36,000.00.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet Working Papers

(Date of Acquisition)

Assets	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Investment in Stock of Company S...	36,000		36,000	
Cash.....	<u>64,000</u>	<u>55,000</u>		<u>119,000</u>
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	15,000		25,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.. . . .		50,000		
Eliminate Parent Company's 90%			45,000	
Minority Interest—10%.....				5,000M
Surplus (Deficit*):				
Company P.....	15,000			15,000S
Company S		10,000*		
Eliminate Parent Company's 90%			9,000*	
Minority Interest—10%.....				1,000*M
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

(Date of Acquisition)

Assets		Liabilities and Net Worth	
Cash.....	\$119,000	Accounts Payable.....	\$ 25,000
		Minority Interest in Com- pany S (10%).....	4,000
		Capital:	
		Capital Stock...	\$75,000
		Surplus.....	15,000
			90,000
	<u>\$119,000</u>		<u>90,000</u>
			<u>\$119,000</u>

Goodwill.—If one company buys the assets and liabilities of another company (instead of its stock), any payment in excess of the value of the net assets acquired is regarded as goodwill. Similarly, if one company acquires control of another company by purchasing its stock, any payment in excess of the book value of the stock acquired may be regarded as a payment for goodwill.

Therefore, if the stock of a subsidiary is purchased at a price in excess of its book value, the balance of the Investment account on the parent company's books will consist of two elements: •

- (1) The book value of the stock acquired.
- (2) The excess payment, or goodwill.

To illustrate, assume that a company paid \$65,000.00 for all of the stock of a subsidiary which had a capital stock of \$50,000.00 and a surplus of \$10,000.00. The balance of the Investment account consists of the following elements:

\$60,000.00—representing the book value of the stock acquired. This element is reciprocal to, and is eliminated against, the Capital Stock and Surplus accounts of the subsidiary.

\$5,000.00—representing a payment for goodwill. This element is not reciprocal to any balance on the subsidiary's books and therefore is not eliminated, but is extended to the Consolidated Balance Sheet column, and is shown in the consolidated balance sheet as goodwill, either as a separate item or added to the goodwill on the books of the parent or subsidiary.

It therefore becomes necessary again to modify our rule for the elimination of intercompany accounts, by adding the words shown below in italics.

Elimination of reciprocals:

Subsidiary's Capital Stock and Surplus or Deficit accounts:

Eliminate reciprocal element—parent company's proportion.

Extend non-reciprocal element (minority interest) to Consolidated Balance Sheet column

Parent company's Investment account:

Eliminate reciprocal element—parent company's proportion of subsidiary's stock and surplus.

Extend non-reciprocal element (goodwill) to the Consolidated Balance Sheet column.

Three illustrations involving goodwill are presented; they differ in the percentage of stock ownership by the parent company and in the matter of the existence of a surplus or deficit on the books of the subsidiary.

First illustration.—At the date of acquisition, the subsidiary has a capital stock of \$50,000.00 and no surplus or deficit. The parent company acquires all of the stock, paying \$57,000.00 therefor.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	Com- pany P	Com- pany S	Elimi- na- tions	Consoli- dated Balance Sheet
Assets				
Investment in Stock of Company S (100%)	57,000			
Eliminate Book Value:				
Capital Stock.....			50,000	
Goodwill.....				7,000G
Cash.....	43,000	60,000		103,000
	<u>100,000</u>	<u>60,000</u>	<u>50,000</u>	<u>110,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	10,000		20,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 100%..			50,000	
Surplus—Company P.....	15,000			15,000
	<u>100,000</u>	<u>60,000</u>	<u>50,000</u>	<u>110,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash.....	\$103,000	Accounts Payable.....	\$ 20,000
Goodwill.....	7,000	Capital:	
		Capital Stock..	\$75,000
		Surplus.....	15,000
	<u>\$110,000</u>		<u>90,000</u>
			<u>\$110,000</u>

Second illustration.—At the date of acquisition, the subsidiary has a capital stock of \$50,000.00 and a surplus of \$10,000.00, making a total book value of \$60,000.00. The parent company acquires a 90% interest, the book value of which is \$54,000.00 and the purchase price \$57,000.00. Hence there is a goodwill element of \$3,000.00 in the price paid by the parent company for its 90% interest in the subsidiary stock.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S (90%)	57,000			
Eliminate Book Value:				
Capital Stock: 90% of \$50,000.00			45,000	
Surplus: 90% of \$10,000.00 . . .			9,000	
Goodwill				3,000G
Cash	43,000	75,000		118,000
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>
Liabilities and Net Worth				
Accounts Payable	10,000	15,000		25,000
Capital Stock:				
Company P	75,000			75,000 ⁻
Company S		50,000		
Eliminate Parent Company's 90% . . .			45,000	
Minority Interest—10%				5,000M
Surplus:				
Company P	15,000			15,000
Company S		10,000		
Eliminate Parent Company's 90% . . .			9,000	
Minority Interest—10%				1,000M
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash	\$118,000	Accounts Payable	\$ 25,000
Goodwill	3,000	Minority Interest—Company S (10%)	6,000
		Capital:	
		Capital Stock . . .	\$75,000
		Surplus	15,000
	<u>\$121,000</u>		<u>90,000</u>
			<u>\$121,000</u>

Third illustration.—At the date of acquisition, the subsidiary has a capital stock of \$50,000.00 and a deficit of \$10,000.00, making a net book value of \$40,000.00. The parent company acquires a 90% interest, the book value of which is \$36,000.00, and the purchase price \$38,000.00. Hence there is a goodwill element of \$2,000.00 in the purchase price.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	Com- pany P	Com- pany S	Elimi- nations	Consoli- dated Balance Sheet
Assets				
Investment in Stock of Co. S (90%) ..	38,000			
Eliminate Book Value:				
Capital Stock: 90% of \$50,000.00			45,000	
Less Deficit: 90% of \$10,000.00 ..			9,000*	
Goodwill.....				2,000G
Cash.....	62,000	55,000		117,000
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	15,000		25,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 90%			45,000	
Minority Interest—10%				5,000M
Surplus (Deficit*):				
Company P.....	15,000			15,000S
Company S.....		10,000*		
Eliminate Parent Company's 90%			9,000*	
Minority Interest—10%				1,000*M
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>

* Indicates a deduction

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash.....	\$117,000	Accounts Payable....	\$ 25,000
Goodwill.....	2,000	Minority Interest—Company S (10%).....	4,000
		Capital:	
		Capital Stock...	\$75,000
		Surplus.....	15,000
	<u>\$119,000</u>		<u>90,000</u>
			<u>\$119,000</u>

Deduction from goodwill.—If the subsidiary has a Goodwill account on its books at the date when the parent company acquires its stock interest, and if the parent company pays less than book value for the stock, the presumption is that the parent company does not recognize the subsidiary's goodwill as conservatively valued and is therefore unwilling to pay book value for the stock. Therefore, when the purchase price is less than the book value of the acquired stock, the deficiency in price should be deducted from the goodwill appearing on the subsidiary's books.

For example, if the subsidiary has a capital stock of \$100,000.00 and a surplus of \$50,000.00, or a total net worth of \$150,000.00, of which \$10,000.00 is represented by a Goodwill account, and if the parent company acquires all of the stock of this subsidiary at a cost of \$142,000.00, it appears that the parent company refused to recognize the existence of a goodwill of \$10,000.00, but based its purchase price on a goodwill of \$2,000.00. In the consolidated working papers, the \$8,000.00 excess of the book value of the subsidiary stock over the purchase price, should be regarded as a deduction from the \$10,000.00 goodwill shown by the subsidiary books.

One more addition to our rule is therefore required:

Elimination of reciprocals:

Subsidiary's Capital Stock and Surplus or Deficit accounts:

Eliminate reciprocal element—parent company's proportion.

Extend non-reciprocal element (minority interest) to Consolidated Balance Sheet column.

Parent company's Investment account:

Eliminate reciprocal element—parent company's proportion of subsidiary's stock and surplus.

Extend non-reciprocal element (*goodwill or deduction from goodwill*) to the Consolidated Balance Sheet column.

Three illustrations involving deductions from goodwill are presented. In each case the subsidiary has a Goodwill account, and the parent company acquires the stock at less than its book value as reflected by the subsidiary's Capital Stock and Surplus accounts.

First illustration.—At the date of acquisition the subsidiary has a capital stock of \$50,000.00 and no surplus or deficit. The parent company acquires all of the stock, paying \$49,000.00 therefor, or \$1,000.00 less than the book value.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Co. S (100%)...	49,000			
Eliminate Book Value:				
Capital Stock.....			50,000	
Deduction from Goodwill....				1,000*G
Goodwill.....		3,000		3,000
Cash.....	51,000	57,000		108,000
	<u>100,000</u>	<u>60,000</u>	<u>50,000</u>	<u>110,000</u>
Liabilities and Net Worth				
Accounts Payable.....	15,000	10,000		25,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 100%			50,000	
Surplus—Company P.....	10,000			10,000
	<u>100,000</u>	<u>60,000</u>	<u>50,000</u>	<u>110,000</u>

* Indicates a deduction.

In the following consolidated balance sheet, the goodwill is shown as \$2,000.00 (the \$3,000.00 on the books of Company S minus the \$1,000.00 negative element arising from the acquisition of Company S stock by Company P).

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash.....	\$108,000	Accounts Payable.....	\$ 25,000
Goodwill.....	2,000	Capital:	
		Capital Stock..	\$75,000
		Surplus.....	10,000
	<u>\$110,000</u>		<u>85,000</u>
			<u>\$110,000</u>

Second illustration.—At the date of acquisition the subsidiary has a capital stock of \$50,000.00 and a surplus of \$10,000.00, making a total book value of \$60,000.00. The

parent company acquires a 90% interest, the book value of which is \$54,000.00 and the purchase price \$53,000.00.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S (90%)	53,000			
Eliminate Book Value:				
Capital Stock: 90% of \$50,000.00..			45,000	
Surplus: 90% of \$10,000.00			9,000	
Deduction from Goodwill.....				1,000*G
Cash.....	47,000	72,000		119,000
Goodwill.....		3,000		3,000G
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>
Liabilities and Net Worth				
Accounts Payable.....	10,000	15,000		25,000
Capital Stock:				
Company P.....	75,000			75,000
Company S.....		50,000		
Eliminate Parent Company's 90%..			45,000	
Minority Interest—10%.....				5,000M
Surplus:				
Company P.....	15,000			15,000
Company S.....		10,000		
Eliminate Parent Company's 90%.			9,000	
Minority Interest—10%.....				1,000M
	<u>100,000</u>	<u>75,000</u>	<u>54,000</u>	<u>121,000</u>

* Indicates a deduction.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash.....	\$119,000	Accounts Payable.....	\$ 25,000
Goodwill.....	2,000	Minority Interest—Company S (10%).....	6,000
		Capital:	
		Capital Stock... ..	\$75,000
		Surplus.....	15,000
	<u>\$121,000</u>		<u>90,000</u>
			<u>\$121,000</u>

Third illustration.—At the date of acquisition the subsidiary has a capital stock of \$50,000.00 and a deficit of \$10,000.00, making a net book value of \$40,000.00. The parent company acquires a 90% interest, the book value of which is \$36,000.00 and the purchase price \$35,000.00.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
 (Date of Acquisition)

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Co. S (90%)..	35,000			
Eliminate Book Value:				
Capital Stock: 90% of \$50,000.00			45,000	
Deficit: 90% of \$10,000.00. . . .			9,000*	
Deduction from Goodwill.				1,000*G
Cash.	65,000	52,000		117,000
Goodwill		3,000		3,000G
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>
Liabilities and Net Worth				
Accounts Payable.	10,000	15,000		25,000
Capital Stock:				
Company P.	75,000			75,000
Company S		50,000		
Eliminate Parent Company's 90%			45,000	
Minority Interest—10%				5,000M
Surplus (Deficit*):				
Company P.	15,000			15,000S
Company S		10,000*		
Eliminate Parent Company's 90%			9,000*	
Minority Interest—10%				1,000*M
	<u>100,000</u>	<u>55,000</u>	<u>36,000</u>	<u>119,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
 (Date of Acquisition)

Cash.	\$117,000	Accounts Payable.	\$ 25,000
Goodwill.	2,000	Minority Interest—Company S (10%).	4,000
		Capital:	
		Capital Stock.	\$75,000
		Surplus.	15,000
	<u>\$119,000</u>		<u>90,000</u>
			<u>\$119,000</u>

In a subsequent chapter we shall consider the treatment of any excess of the book value of stock acquired over the purchase price, if no goodwill appears on the books of the subsidiary whose stock is acquired at less than book value.

Intercompany receivables and payables.—A consolidated balance sheet shows the financial condition of a group of companies with all intercompany relationships eliminated.

Related companies frequently buy from and sell to each other on credit, so that the accounts receivable of one company and the accounts payable of another company contain reciprocal intercompany accounts. The amounts of such reciprocal intercompany receivables and payables should be eliminated in the Eliminations column of the consolidated working papers, and the consolidated balance sheet should include only amounts receivable from and payable to others.

If the capital of one company is inadequate, one of the other related companies may make more or less permanent advances to it. The reciprocal accounts with these advances should also be eliminated in the consolidated working papers.

If the intercompany indebtedness takes the form of a note, the amount thereof should also be eliminated from the receivables and payables in the consolidated working papers.

The following partial working papers show the method of making such eliminations.

Consolidated Balance Sheet Working Papers

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Accounts Receivable.....	165,000	60,000	12,000	213,000
Notes Receivable—Company S.....	25,000		25,000	
Liabilities				
Accounts Payable.....	90,000	30,000	12,000	108,000
Notes Payable—Company P.....		25,000	25,000	

Company S owes Company P \$12,000.00 for merchandise; this amount is included in Company P's accounts receivable (which total \$165,000.00) and in Company S's accounts payable (which total \$30,000.00). The \$12,000.00 is eliminated from the accounts receivable and accounts payable, so that the consolidated balance sheet shows only the amounts of the accounts with outsiders.

Company S also owes Company P \$25,000.00 on a note; the amount receivable appears as an asset in Company P's balance sheet and as a liability in Company S's balance sheet; this intercompany obligation is also eliminated.

CHAPTER 44

PARENT AND SUBSIDIARY ACCOUNTING (Continued)— CONSOLIDATED BALANCE SHEETS SUBSEQUENT TO ACQUISITION

Parent's entries for subsidiary profits, losses, and dividends.—Before dealing with the preparation of consolidated balance sheets at dates subsequent to the acquisition of the subsidiary stock by the parent company, it will be desirable to consider the entries to be made by the parent company in recording the profits, losses, and dividends of the subsidiary.* For purposes of illustration, we shall assume the following facts:

Company *P* acquired all of the stock of Company *S* on January 1, 1934.

During the six months ended June 30, 1934, Company *S* made a profit of \$20,000.00.

During the six months ended December 31, 1934, Company *S* lost \$10,000.00, and paid a dividend of \$5,000.00.

(1) **Subsidiary profit—\$20,000.00:** The parent company's entry for the subsidiary's profit of the first six months should be:

Investment in Stock of Company <i>S</i>	20,000.00	
Income from Company <i>S</i>		20,000.00
To take up the subsidiary's profit for the six months ended June 30, 1934.		

Explanation of debit: Subsidiary profits increase the net assets of the subsidiary, which are represented on the parent company's books by the debit balance of the Investment account. The increase in the net assets of the subsidiary

* The methods described on the following pages are standard procedure. A proposed refinement is discussed in Chapter 47.

should therefore be reflected on the parent company's books by a debit to the Investment account.

Explanation of credit: Profits earned by the subsidiary are earned for the benefit of the parent company; therefore the parent company is justified in taking up the profit by a credit to an income account.

(2) Subsidiary loss—\$10,000.00: The parent company's entry for the subsidiary's loss of the second six months should be:

Loss of Company S.	10,000 00	
Investment in Stock of Company S		10,000.00
To take up the subsidiary's loss for the six months ended December 31, 1934.		

Explanation of debit: If the parent company takes up the subsidiary's profit by a credit to an income account, it should take up the subsidiary's loss by a debit to a loss account.

Explanation of credit: Subsidiary losses decrease the net assets of the subsidiary, which are represented on the parent company's books by the debit balance of the Investment account. The decrease in the net assets of the subsidiary should therefore be reflected on the parent company's books by a credit to the Investment account.

(3) Subsidiary dividend—\$5,000.00: The parent company's entry for the subsidiary's dividend should be:

Cash	5,000.00	
Investment in Stock of Company S		5,000.00
To record the receipt of a dividend from the subsidiary.		

Explanation of debit: The debit to Cash records the increase in the cash in the parent company's possession.

Explanation of credit: The subsidiary's net assets are decreased by the payment of a dividend. The balance in the Investment account, which

represents the net assets of the subsidiary, should therefore be reduced by a credit.

If time elapses between the declaration and the payment of the dividend, the parent company may debit Dividends Receivable and credit the Investment account, to record the declaration of the dividend. Subsequently, it will debit Cash and credit Dividends Receivable, to record the collection of the dividend.

If the parent company had owned only 90% of the subsidiary stock, its entries to record its proportion of the subsidiary's profits, losses, and dividends would have been:

Investment in Stock of Company <i>S</i>	18,000 00	
Income from Company <i>S</i>		18,000.00
To take up 90% of the profit of Company <i>S</i> for the six months ended June 30, 1934.		
Loss of Company <i>S</i>	9,000.00	
Investment in Stock of Company <i>S</i> ..		9,000.00
To take up 90% of the loss of Company <i>S</i> for the six months ended December 31, 1934.		
Cash.....	4,500.00	
Investment in Stock of Company <i>S</i> ..		4,500 00
To record the dividend received from Company <i>S</i> .		

Rule for eliminations.—The rule for making eliminations in consolidated balance sheet working papers at the date of acquisition, as developed in the preceding chapter, was stated as follows:

Subsidiary's Capital Stock and Surplus accounts:

 Eliminate reciprocal element—parent company's proportion.

 Extend non-reciprocal element (minority interest, if any) to the Consolidated Balance Sheet column.

Parent company's Investment account:

 Eliminate reciprocal element—parent company's proportion of subsidiary's stock and surplus.

 Extend non-reciprocal element (goodwill or deduction from goodwill, if any) to the Consolidated Balance Sheet column.

The same rule for eliminations can be applied at all balance sheet dates subsequent to acquisition, if the parent company has taken up subsidiary profits, losses, and dividends in the manner illustrated by the preceding journal entries.

Outline and purposes of illustrations.—Four illustrative cases are used in this chapter. All of the cases are based on the assumption that Company *S* had a capital stock of \$100,000.00 and a surplus of \$50,000.00 on January 1, 1934, the date at which Company *P* acquired its stock interest. The amounts of subsidiary profits, losses, and dividends are the same as those used in the preceding journal entries: namely, a profit of \$20,000.00 during the first six months of 1934, and a loss of \$10,000.00 and a payment of dividends of \$5,000.00 during the second six months. Consolidated balance sheets are prepared as of December 31, 1934. The cases differ as follows:

Case A: No minority interest; no goodwill.

Case B: A 10% minority interest; no goodwill.

Case C: A 10% minority interest; goodwill.

Case D: A 10% minority interest; deduction from goodwill.

These cases are used in three groups of illustrations for the following purposes:

First group of illustrations: To demonstrate (by showing the parent company's and the subsidiary company's accounts) that the rule for eliminations developed in the preceding chapter (and applied there in the preparation of consolidated balance sheets at the date of acquisition) can be applied at dates subsequent to acquisition if the parent company has recorded subsidiary profits, losses, and dividends in the manner described at the beginning of this chapter.

Second group of illustrations: To show how consolidated balance sheets at dates subsequent to acquisition may be prepared from formal working papers.

Third group of illustrations: To show how consolidated balance sheets at dates subsequent to acquisition may be prepared without formal working papers.

First Group of Illustrations

No consolidated balance sheets are prepared in this group of illustrations, as the object is merely to prove that the rule for eliminations at the date of acquisition can be applied at subsequent dates if the procedure for recording subsidiary profits, losses, and dividends described on the preceding pages of this chapter has been used by the parent company. The student should note that, in each of the four cases, the elimination of the reciprocal element (the parent company's proportion of the subsidiary's capital stock and surplus at the date of the consolidated balance sheet) leaves the following non-reciprocal elements, if any:

In the subsidiary's Capital Stock and Surplus accounts—the non-reciprocal element of minority interest.

In the parent company's Investment account—the non-reciprocal goodwill element equal to the difference between the cost of the subsidiary stock and its book value at the date of acquisition.

Case A: NO MINORITY INTEREST; NO GOODWILL.—Company *P* acquired all of the stock of Company *S* on January 1, 1934, paying exactly book value, \$150,000.00; hence there are no non-reciprocal elements of minority interest or goodwill. Following is a summary of the subsidiary's Capital Stock and Surplus accounts and the parent company's Investment account for the year 1934.

	<u>SUBSIDIARY'S</u>		Parent's
	<u>Capital</u>	<u>Surplus</u>	Investment
	<u>Stock</u>		Account
			(100%)
Balances, January 1, 1934.....	\$100,000	\$50,000	\$150,000
Additions, June 30, 1934:			
Profit.....		20,000	20,000
Deductions*, December 31, 1934:			
Loss.....		10,000*	10,000*
Dividend.....		5,000*	5,000*
Balances, December 31, 1934.....	<u>\$100,000</u>	<u>\$55,000</u>	<u>\$155,000</u>
Reciprocal Element—Parent Company's Interest in Stock and Surplus.....	<u>100,000</u>	<u>55,000</u>	<u>155,000</u>
Non-Reciprocal Elements:			
Minority Interest.....			
Goodwill.....			

When the reciprocal element (the parent company's interest in the subsidiary stock and surplus at the end of the year) is eliminated, no non-reciprocal element remains in the subsidiary's Stock and Surplus accounts, because there is no minority interest; and no non-reciprocal element remains in the Investment account, because no payment was made for goodwill.

Case B: TEN PER CENT MINORITY INTEREST; NO GOODWILL. Company *P* acquired only 90% of the stock of Company *S* on January 1, 1934; hence there is a 10% minority interest. The book value of the stock acquired was 90% of \$150,000.00, or \$135,000.00; Company *P* paid \$135,000.00 for the stock; hence there was no payment for goodwill.

	SUBSIDIARY'S		Parent's Invest- ment Account (90%)
	Capital Stock	Surplus	
Balances, January 1, 1934.....	\$100,000	\$50,000	\$135,000
Additions, June 30, 1934:			
Profit.....		20,000	18,000
Deductions*, December 31, 1934:			
Loss.....		10,000*	9,000*
Dividend.....		5,000*	4,500*
Balances, December 31, 1934.....	\$100,000	\$55,000	\$139,500
Reciprocal Element—Parent Company's Interest in Stock and Surplus—90%...	90,000	49,500	139,500
Non-Reciprocal Elements:			
Minority Interest—10%.....	\$ 10,000	\$ 5,500	
Goodwill.....			

When the reciprocal element (the parent company's 90% interest in the subsidiary's stock and surplus at the end of the year) is eliminated, non-reciprocal elements remain in the subsidiary's Stock and Surplus accounts, because there is a 10% minority interest; but no non-reciprocal element remains in the Investment account, because there was no payment for goodwill.

Case C: TEN PER CENT MINORITY INTEREST; GOODWILL.— Company *P* acquired only 90% of the stock of Company *S* on January 1, 1934; hence there is a 10% minority interest. The book value of the stock acquired was 90% of \$150,000.00, or \$135,000.00; Company *P* paid \$138,000.00 for the stock; hence there was a goodwill payment of \$3,000.00.

	SUBSIDIARY'S		Parent's Invest- ment Account (90%)
	Capital Stock	Surplus	
Balances, January 1, 1934.....	\$100,000	\$50,000	\$138,000
Additions, June 30, 1934:			
Profit.....		20,000	18,000
Deductions*, December 31, 1934:			
Loss.....		10,000*	9,000*
Dividend.....		5,000*	4,500*
Balances, December 31, 1934 ..	\$100,000	\$55,000	\$142,500
Reciprocal Element—Parent Company's Interest in Stock and Surplus—90% . .	90,000	49,500	139,500
Non-Reciprocal Elements:			
Minority Interest—10%	\$ 10,000	\$ 5,500	
Goodwill.....			\$ 3,000

When the reciprocal element (the parent company's 90% interest in the stock and surplus of the subsidiary at the end of the year) is eliminated, non-reciprocal elements remain in the subsidiary's Stock and Surplus accounts, because there is a 10% minority interest; a non-reciprocal element also remains in the Investment account, representing the payment made for goodwill.

Case D: TEN PER CENT MINORITY INTEREST; DEDUCTION FROM GOODWILL.—Company *P* acquired only 90% of the stock of Company *S* on January 1, 1934, leaving a 10% minority interest. The book value of the stock acquired was 90% of \$150,000.00, or \$135,000.00; the price paid was \$130,000.00, leaving a deduction from goodwill of \$5,000.00.

	SUBSIDIARY'S		Parent's Invest- ment Account (90%)
	Capital Stock	Surplus	
Balances, January 1, 1934.....	\$100,000	\$50,000	\$130,000
Additions, June 30, 1934:			
Profit.....		20,000	18,000
Deductions*, December 31, 1934:			
Loss.....		10,000*	9,000*
Dividend.....		5,000*	4,500*
Balances, December 31, 1934.....	\$100,000	\$55,000	\$134,500
Reciprocal Element—Parent Company's Interest in Stock and Surplus—90% . . .	90,000	49,500	139,500
Non-Reciprocal Elements:			
Minority Interest—10%.....	\$ 10,000	\$ 5,500	
Deduction from Goodwill.....			5,000*

When the reciprocal elements are eliminated, non-reciprocal elements remain in the subsidiary's Stock and Surplus accounts because there is a 10% minority interest; a negative non-reciprocal element appears in the Investment account, representing the deduction from goodwill.

Second Group of Illustrations

Working papers.—The four preceding cases will now be repeated, using the customary working papers to show the elimination of the reciprocal elements, and the extension of non-reciprocal elements (if any) to the Consolidated Balance Sheet columns.

Case A: NO MINORITY INTEREST; NO GOODWILL.—By reference to the first of the four preceding cases, it will be noted that there is no minority interest, and that no goodwill payment was made by the parent company. (The \$10,000.00 goodwill appearing in the consolidated balance sheet is the amount shown on the subsidiary's books.)

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Cash	45,000	20,000		65,000
Accounts Receivable	95,000	75,000		170,000
Inventory	125,000	70,000		195,000
Investment in Stock of Company S . .	155,000			
Eliminate Book Value:				
Capital Stock			100,000	
Surplus			55,000	
Goodwill		10,000		10,000
	<u>420,000</u>	<u>175,000</u>	<u>155,000</u>	<u>440,000</u>
Liabilities and Net Worth				
Accounts Payable	40,000	20,000		60,000
Capital Stock:				
Company P	300,000			300,000
Company S		100,000		
Eliminate Company P's 100% . .			100,000	
Surplus:				
Company P	80,000			80,000
Company S		55,000		
Eliminate Company P's 100% . .			55,000	
	<u>420,000</u>	<u>175,000</u>	<u>155,000</u>	<u>440,000</u>

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 65,000	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Net Worth:	
Inventory.....	195,000	Capital Stock..	\$300,000
Goodwill.....	10,000	Surplus.....	<u>80,000</u>
	<u>\$440,000</u>		<u>380,000</u>
			<u>\$440,000</u>

Case B: TEN PER CENT MINORITY INTEREST; NO GOODWILL.—By reference to the second of the preceding cases, it will be noted that Company *P* bought only 90% of the subsidiary stock, leaving a 10% minority interest. The stock was purchased at its exact book value, with no goodwill payment and no deduction from goodwill.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet Working Papers

December 31, 1934

	Com- pany <i>P</i>	Com- pany <i>S</i>	Elimi- nations	Consoli- dated Balance Sheet
Assets				
Cash.....	59,500	20,000		79,500
Accounts Receivable.....	95,000	75,000		170,000
Inventory.....	125,000	70,000		195,000
Investment in Stock of Company <i>S</i> ..	139,500			
Eliminate Book Value—90%:				
Capital Stock.....			90,000	
Surplus.....			49,500	
Goodwill.....		10,000		10,000
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>
Liabilities and Net Worth				
Accounts Payable.....	40,000	20,000		60,000
Capital Stock:				
Company <i>P</i>	300,000			300,000
Company <i>S</i>		100,000		
Eliminate Company <i>P</i> 's 90%.....			90,000	
Minority Interest—10%.....				10,000M
Surplus:				
Company <i>P</i>	79,000			79,000
Company <i>S</i>		55,000		
Eliminate Company <i>P</i> 's 90%.....			49,500	
Minority Interest—10%.....				5,500M
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 79,500	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Minority Interest in Co. S.	15,500
Inventory.....	195,000	Net Worth:	
Goodwill.....	10,000	Capital Stock.	\$300,000
		Surplus.....	79,000
	<u>\$454,500</u>		<u>379,000</u>
			<u>\$454,500</u>

Case C: TEN PER CENT MINORITY INTEREST; GOODWILL.—By reference to the third of the preceding cases, it will be noted that Company P bought only 90% of the subsidiary stock, leaving a 10% minority interest. The price paid was \$3,000.00 more than the book value of the stock; this amount represents a payment for goodwill.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet Working Papers

December 31, 1934

Assets	Com- pany P	Com- pany S	Elimi- nations	Consoli- dated Balance Sheet
Cash.....	56,500	20,000		76,500
Accounts Receivable.....	95,000	75,000		170,000
Inventory.....	125,000	70,000		195,000
Investment in Stock of Company S	142,500			
Eliminate Book Value—90%:				
Capital Stock.....			90,000	
Surplus.....			49,500	
Goodwill.....				3,000G
Goodwill.....		10,000		10,000G
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>
Liabilities and Net Worth				
Accounts Payable.....	40,000	20,000		60,000
Capital Stock:				
Company P.....	300,000			300,000
Company S.....		100,000		
Eliminate Company P's 90%.....			90,000	
Minority Interest—10%.....				10,000M
Surplus:				
Company P.....	79,000			79,000
Company S.....		55,000		
Eliminate Company P's 90%.....			49,500	
Minority Interest—10%.....				5,500M
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>

Note that the goodwill on the books of Company S and

the goodwill payment made in the acquisition of its stock are combined in the following consolidated balance sheet:

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash	\$ 76,500	Accounts Payable	\$ 60,000
Accounts Receivable	170,000	Minority Interest in Co. S—	
Inventory	195,000	10%	15,500
Goodwill	13,000	Net Worth:	
		Capital Stock	\$300,000
		Surplus	79,000
			<u>379,000</u>
	<u>\$454,500</u>		<u>\$454,500</u>

Case D: TEN PER CENT MINORITY INTEREST; DEDUCTION FROM GOODWILL.—By reference to the fourth of the preceding cases, it will be noted that there was a 10% minority interest, and that the parent company bought the subsidiary stock at \$5,000.00 less than its book value.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet Working Papers

December 31, 1934

Assets	Com- pany <i>P</i>	Com- pany <i>S</i>	Elimi- nations	Consoli- dated Balance Sheet
Cash	64,500	20,000		84,500
Accounts Receivable	95,000	75,000		170,000
Inventory	125,000	70,000		195,000
Investment in Stock of Company <i>S</i>	134,500			
Eliminate Book Value—90%:				
Capital Stock			90,000	
Surplus			49,500	
Deduction from Goodwill				5,000*G
Goodwill		10,000		10,000G
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>
Liabilities and Net Worth				
Accounts Payable	40,000	20,000		60,000
Capital Stock:				
Company <i>P</i>	300,000			300,000
Company <i>S</i>		100,000		
Eliminate Company <i>P</i> 's 90%			90,000	
Minority Interest—10%				10,000M
Surplus:				
Company <i>P</i>	79,000			79,000
Company <i>S</i>		55,000		
Eliminate Company <i>P</i> 's 90%			49,500	
Minority Interest—10%				5,500M
	<u>419,000</u>	<u>175,000</u>	<u>139,500</u>	<u>454,500</u>

Note that, in the following consolidated balance sheet, the amount shown as goodwill is the \$10,000.00 balance on the books of Company *S* minus the \$5,000.00 goodwill deduction resulting from the purchase of the stock of Company *S* at less than book value.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 84,500	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Minority Int. in Co. <i>S</i> —	
Inventory.....	195,000	10%.....	15,500
Goodwill.....	5,000	Net Worth:	
		Capital Stock.....	\$300,000
		Surplus.....	79,000
			<u>379,000</u>
	<u>\$454,500</u>		<u>\$454,500</u>

Third Group of Illustrations

Consolidated balance sheets without working papers.— Although students should be thoroughly familiar with the method of preparing consolidated balance sheet working papers, it is often a simple matter to prepare a consolidated balance sheet without formal working papers. To show how this may be done, we shall again repeat the four cases already given in this chapter. The procedure for preparing a consolidated balance sheet without formal working papers is summarized as follows:

- (1) On scratch paper or in simple working papers, deduct the reciprocal element (parent company's interest in subsidiary stock and surplus) from the Investment account, to determine any goodwill or negative goodwill element, and from the subsidiary's Capital Stock and Surplus accounts, to determine any minority interest.
- (2) Enter in the consolidated balance sheet:
 - (a) The combined balances of similar asset accounts. Do not include the Investment account. Adjust the combined goodwill balances by any positive or negative goodwill element determined in (1).
 - (b) The combined balances of similar liability accounts.
 - (c) The minority interest determined in (1).

- (d) The parent company's capital stock and surplus under the net worth caption.

Case A: NO MINORITY INTEREST; NO GOODWILL.—Following are the balance sheets of the two companies used in the first case. (See pages 217 and 220.) The parent company owns all of the subsidiary stock

	<u>Company P</u>	<u>Company S</u>
Assets		
Cash	\$ 45,000.00	\$ 20,000.00
Accounts Receivable	95,000.00	75,000.00
Inventory	125,000.00	70,000.00
Investment in Stock of Company S—100%	155,000.00	
Goodwill		10,000.00
	<u>\$420,000.00</u>	<u>\$175,000.00</u>
Liabilities and Net Worth		
Accounts Payable	\$ 40,000.00	\$ 20,000.00
Capital Stock	300,000.00	100,000.00
Surplus	80,000.00	55,000.00
	<u>\$420,000.00</u>	<u>\$175,000.00</u>

The consolidated balance sheet appears on page 226. It was prepared by the procedure described on page 224.

- (1) The reciprocal element was deducted from the Investment account and from the subsidiary's Stock and Surplus accounts as shown below. No goodwill or minority interest remained.

	<u>SUBSIDIARY'S</u>		Parent's Investment Account (100%)
	Capital Stock	Surplus	
Balances	\$100,000	\$55,000	\$155,000
Deduct Reciprocal Element—100%	<u>100,000</u>	<u>55,000</u>	<u>155,000</u>
Non-Reciprocal Elements	<u>—</u>	<u>—</u>	<u>—</u>

- (2) The following amounts were entered in the consolidated balance sheet:
- (a) Combined balances of asset accounts: Cash, Accounts Receivable, Inventory, Goodwill. (No adjustment of the goodwill.)
 - (b) Combined balances of liability accounts: Accounts Payable.
 - (c) Minority interest: none.
 - (d) Net worth: parent company's capital stock and surplus.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash	\$ 65,000	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Net Worth:	
Inventory.....	195,000	Capital Stock..	\$300,000
Goodwill.....	10,000	Surplus.....	80,000
	<u>\$440,000</u>		<u>380,000</u>
			<u>\$440,000</u>

Case B: TEN PER CENT MINORITY INTEREST; NO GOODWILL. Following are the balance sheets used in the second case. (See pages 218 and 221.) The parent company owns 90% of the stock of the subsidiary.

	Company P	Company S
Assets		
Cash.....	\$ 59,500.00	\$ 20,000.00
Accounts Receivable.....	95,000.00	75,000.00
Inventory.....	125,000.00	70,000.00
Investment in Stock of Company S—90%	139,500.00	
Goodwill.....		10,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>
Liabilities and Net Worth		
Accounts Payable.....	\$ 40,000.00	\$ 20,000.00
Capital Stock.....	300,000.00	100,000.00
Surplus.....	79,000.00	55,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>

The consolidated balance sheet appears on page 227.

- (1) The reciprocal element was deducted from the Investment account and from the subsidiary's Capital Stock and Surplus accounts, to determine any goodwill or minority interest, thus:

	SUBSIDIARY'S		Parent's
	Capital	Surplus	Investment
	Stock	Surplus	Account
			(90%)
Balances.....	\$100,000	\$55,000	\$139,500
Deduct Reciprocal Element—90%..	<u>90,000</u>	<u>49,500</u>	<u>139,500</u>
Non-Reciprocal Elements:			
Minority Interest—10%.....	\$ 10,000	\$ 5,500	
Goodwill.....			

- (2) The following amounts were entered in the consolidated balance sheet:
 - (a) Combined balances of asset accounts: Cash,

Accounts Receivable, Inventory, Goodwill.
(No adjustment of goodwill.)

- (b) Combined balances of liability accounts: Accounts Payable.
- (c) Minority interest determined in (1).
- (d) Net worth: parent company's capital stock and surplus.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash	\$ 79,500	Accounts Payable.....	\$ 60,000
Accounts Receivable	170,000	Minority Int. in Co. S—10%	15,500
Inventory	195,000	Net Worth:	
Goodwill.....	10,000	Capital Stock. \$300,000	
		Surplus.....	79,000
	<u>\$454,500</u>		<u>379,000</u>
			<u>\$454,500</u>

Case C: TEN PER CENT MINORITY INTEREST; GOODWILL.—
Following are the balance sheets used in the third case.
(See pages 218 and 222). The parent company owns 90% of the subsidiary stock.

	Company P	Company S
Assets		
Cash.....	\$ 56,500.00	\$ 20,000.00
Accounts Receivable	95,000.00	75,000.00
Inventory.....	125,000.00	70,000.00
Investment in Stock of Company S—90%	142,500.00	
Goodwill		10,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>
Liabilities and Net Worth		
Accounts Payable.....	\$ 40,000.00	\$ 20,000.00
Capital Stock	300,000.00	100,000.00
Surplus.....	79,000.00	55,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>

(1) Determination of minority interest and goodwill:

	SUBSIDIARY'S		Parent's Investment Account (90%)
	Capital Stock	Surplus	
Balances	\$100,000.00	\$55,000.00	\$142,500.00
Reciprocals To Be Eliminated—90%	<u>90,000.00</u>	<u>49,500.00</u>	<u>139,500.00</u>
Non-Reciprocals:			
Minority Interest.....	\$ 10,000.00	\$ 5,500.00	
Goodwill.....			<u>\$ 3,000.00</u>

(2) The following amounts were entered in the consolidated balance sheet:

- (a) Combined balances of asset accounts: Cash, Accounts Receivable, Inventory. The amount shown as Goodwill in the consolidated balance sheet is the sum of the \$10,000.00 account on the books of Company S and the \$3,000.00 goodwill element determined in (1) above.
- (b) Combined amounts of liability accounts: Accounts Payable.
- (c) Minority interest of \$15,500.00, as determined in (1) above.
- (d) Net worth: parent company's capital stock and surplus.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 76,500	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Minority Int. in Co. S—10%	15,500
Inventory.....	195,000	Net Worth:	
Goodwill.....	13,000	Capital Stock..	\$300,000
		Surplus.....	79,000
			<u>379,000</u>
	<u>\$454,500</u>		<u>\$454,500</u>

Case D: TEN PER CENT MINORITY INTEREST; DEDUCTION FROM GOODWILL.—Following are the balance sheets used in the fourth case. (See pages 219 and 223.) The parent company owns 90% of the subsidiary stock.

	Company P	Company S
Assets		
Cash.....	\$ 64,500.00	\$ 20,000.00
Accounts Receivable.....	95,000.00	75,000.00
Inventory.....	125,000.00	70,000.00
Investment in Stock of Company S—90%.....	134,500.00	
Goodwill.....		10,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>
Liabilities and Net Worth		
Accounts Payable.....	\$ 40,000.00	\$ 20,000.00
Capital Stock.....	300,000.00	100,000.00
Surplus.....	79,000.00	55,000.00
	<u>\$419,000.00</u>	<u>\$175,000.00</u>

(1) Determination of minority interest and goodwill:

	SUBSIDIARY'S		Parent's Investment Account (90%)
	Capital Stock	Surplus	
Balances.....	\$100,000.00	\$55,000.00	\$134,500.00
Reciprocals To Be Eliminated—90%	90,000.00	49,500.00	139,500.00
Non-Reciprocal Elements:			
Minority Interest—10%.....	\$ 10,000.00	\$ 5,500.00	
Deduction from Goodwill			\$ 5,000.00*

(2) The following amounts were entered in the consolidated balance sheet below:

- (a) Combined balances of asset accounts: Cash, Accounts Receivable, Inventory. The Goodwill in the consolidated balance sheet is the amount shown in the balance sheet of Company S, minus the goodwill deduction determined in (1) above.
- (b) Combined balances of liability accounts: Accounts Payable.
- (c) Minority interest of \$15,500.00, as determined in (1) above.
- (d) Net worth: parent company's capital stock and surplus.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 84,500	Accounts Payable.....	\$ 60,000
Accounts Receivable.....	170,000	Minority Int. in Co. S—10%	15,500
Inventory.....	195,000	Net Worth:	
Goodwill.....	5,000	Capital Stock..	\$300,000
		Surplus.....	79,000
	<u>\$454,500</u>		<u>379,000</u>
			<u>\$454,500</u>

CHAPTER 45

PARENT AND SUBSIDIARY ACCOUNTING (Continued) CONSOLIDATED BALANCE SHEET IF INVESTMENT IS CARRIED AT COST

Carrying investment at cost.—The preceding chapter explained the journal entries by which a parent company may debit its Investment account with subsidiary profits, and credit its Investment account with subsidiary losses and dividends.

Some parent companies, however, make no entries in the Investment account except those to record the cost of the stock purchased. No entries whatever are made for subsidiary profits and losses, but dividends from the subsidiary are recorded by debiting Cash and crediting Dividends from Subsidiary (or some similar account), which is regarded as an income account and is closed to Profit and Loss.

The two methods of accounting used by parent companies are compared below.

	Profits, Losses, and Dividends Recorded Through Investment Account (First Method)	Dividends Recorded as Income (Second Method)
<i>Profit:</i>	Investment in Company S.. 20,000 Income from S. 20,000	No entry.
<i>Loss:</i>	Loss from S. 10,000 Investment in Company S.. 10,000	No entry.
<i>Dividend:</i>	Cash 5,000 Investment in Company S.. 5,000	Cash 5,000 Dividends from Company S.. 5,000

If this method is used, the Income and Loss accounts are closed to Profit and Loss and thence to Surplus.

If this method is used, the Dividends account is closed to Profit and Loss and thence to Surplus.

In the following discussion and illustrations, we shall show only the ultimate effect upon Surplus, without indicating the entries to be made in the Income, Loss, or Dividend accounts.

Effect of the two methods on the Investment accounts.—The Investment accounts resulting from the two methods of accounting are shown below. (It is assumed that the subsidiary stock was purchased for \$100,000.00.)

Investment Account (First Method)		Investment Account (Second Method)	
Cost....	100,000	Cost....	100,000
Profit...	20,000		
		Loss....	10,000
		Dividend	5,000

If the first method of accounting is used, increases in the net assets of the subsidiary, caused by profits, are reflected by corresponding increases in the balance of the Investment account; and decreases in the net assets of the subsidiary, caused by losses and dividends, are reflected by corresponding decreases in the balance of the Investment account.

If the second method of accounting is used, the Investment is carried at cost.

Obviously, the first method is preferable because the carrying value of the investment is increased and decreased in accordance with increases and decreases in the subsidiary net assets which underlie and give value to the investment.

Effect of the two methods on parent's Surplus.—The effect of the two methods on the parent company's Surplus is shown below. (It is assumed, for the sake of simplicity, that the parent company has no surplus from its own operations.)

Surplus (First Method)		Surplus (Second Method)	
Loss.....	10,000		
		Dividend.	5,000
		Profit...	20,000

If the first method is used, the parent company's Surplus account is debited with its proportion of the subsidiary's loss, and credited with its proportion of the subsidiary's profit.

If the second method is used, the parent company's Surplus account is credited with dividends received from the subsidiary.

Obviously, the first method is preferable because it shows the parent company's true net income from the investment.

The dividends received from a subsidiary may be greater or less than the parent company's share of the subsidiary's net income. In fact, the subsidiary might incur a loss and still pay dividends from previously accumulated surplus; in that event, the second method would result in crediting the parent company's surplus with the dividend instead of debiting it with the loss.

Differences in account balances.—The preceding chapter discussed the method of preparing consolidated balance sheets when the parent company takes up its share of subsidiary profits, losses, and dividends. This chapter explains the procedure of preparing consolidated balance sheets if the parent company carries the investment at cost and takes up subsidiary dividends as income. Some difference in procedure is required because the balances in the parent company's Investment and Surplus accounts differ under the two methods of accounting. Before discussing the procedure to be followed if the investment is carried at cost, let us consider four illustrations which show what the differences in account balances will be.

In all of the illustrations it is assumed that the parent company purchased the subsidiary stock on January 1, 1934, at which date the subsidiary had a capital stock of \$100,000.00 and a surplus of \$50,000.00. It is also assumed that the parent company has no surplus arising from its own operations.

First illustration.—The parent company purchased all of the subsidiary stock, paying book value therefor, or \$150,000.00. During the year, the subsidiary made a profit of \$10,000.00 and paid a dividend of \$6,000.00.

		Parent Company's Accounts			
		(Method 1)		(Method 2)	
Subsidiary's Surplus		Investment Account	Surplus	Investment Account	Surplus
\$50,000	Balances—January 1.....	\$150,000		\$150,000	
10,000	Profit.....	10,000	\$10,000		
6,000*	Dividend.....	6,000*			\$6,000
<u>\$54,000</u>	Balances—December 31...	<u>\$154,000</u>	<u>\$10,000</u>	<u>\$150,000</u>	<u>\$6,000</u>
	Differences in parent company's accounts by the two methods—equal to increase in subsidiary's surplus since the date of acquisition.....			4,000	4,000

* Decrease.

Under the second method of accounting, the parent company has not increased its Investment account for the \$4,000.00 increase in subsidiary net assets and surplus since acquisition; moreover, in its Surplus account, it has taken up only the \$6,000.00 dividend instead of the \$10,000.00 profit, thus understating its surplus \$4,000.00.

To bring the balances obtained by Method 2 into agreement with the balances which would have been obtained by Method 1, the parent company could make the following adjustment:

Investment in Company S.....	4,000 00	
Surplus.....		4,000.00
To take up the subsidiary profits not received as dividends. Amount is equal to the increase in subsidiary's net assets and surplus since acquisition.		

Second illustration.—This illustration is the same as the preceding one, except that the parent company purchased only 90% of the subsidiary stock, paying book value therefor, or 90% of \$150,000.00, or \$135,000.00.

		Parent Company's Accounts			
		(Method 1)		(Method 2)	
Sub- sidiary's Surplus		Invest- ment Account	Sur- plus	Invest- ment Account	Sur- plus
\$50,000	Balances—January 1.....	\$135,000		\$135,000	
10,000	Profit.....	9,000	\$9,000		
6,000*	Dividend.....	5,400*			\$5,400
\$54,000	Balances—December 31....	\$138,600	\$9,000	\$135,000	\$5,400
	Differences in parent company's accounts by the two methods—equal to 90% of the \$4,000.00 increase in the subsidiary's net assets and surplus since the date of acquisition.....			3,600	3,600

* Decrease.

To bring the balances obtained by Method 2 into agreement with those which would have been obtained by Method 1, the parent company could make the following adjustment:

Investment in Company S.....	3,600.00	
Surplus.....		3,600.00
To take up our share of subsidiary profits not received as dividends. Amount is equal to 90% of the increase in subsidiary's surplus since acquisition.		

Third illustration.—The parent company bought all of the subsidiary stock, paying its book value, or \$150,000.00. During the year, the subsidiary lost \$10,000.00, and paid a \$6,000.00 dividend from previously accumulated surplus.

		Parent Company's Accounts			
		<i>(Method 1)</i>		<i>(Method 2)</i>	
Sub- sidiary's Surplus		Invest- ment	Surplus	Invest- ment	Surplus
		Account		Account	
\$50,000	Balances—January 1....	\$150,000		\$150,000	
10,000*	Loss.....	10,000*	\$10,000*		
6,000*	Dividend.....	6,000*			\$ 6,000
\$34,000	Balances—December 31.	\$134,000	\$10,000*	\$150,000	\$ 6,000
	Differences in parent company's accounts by the two methods—equal to decrease in subsidiary's surplus since the date of acquisition				
				16,000*	16,000*

* Decrease.

To bring the balances obtained by Method 2 into agreement with the balances which would have been obtained by Method 1, the parent company could make the following adjustment:

Surplus.....	16,000.00	
Investment in Company S.....		16,000.00
To adjust our accounts by taking up the decrease in the subsidiary's surplus since the date of acquisition.		

Fourth illustration.—This illustration is the same as the preceding one, except that the parent company purchased only 90% of the subsidiary stock, paying book value therefor, or 90% of \$150,000.00, or \$135,000.00.

		Parent Company's Accounts			
		<i>(Method 1)</i>		<i>(Method 2)</i>	
Sub- sidiary's Surplus		Invest- ment	Surplus	Invest- ment	Surplus
		Account		Account	
\$50,000	Balances—January 1....	\$135,000		\$135,000	
10,000*	Loss.....	9,000*	\$ 9,000*		
6,000*	Dividend.....	5,400*			\$ 5,400
\$34,000	Balances—December 31.	\$120,600	\$ 9,000*	\$135,000	\$ 5,400
	Differences in parent company's accounts by the two methods—equal to 90% of the \$16,000.00 decrease in the subsidiary's surplus since the date of acquisition.....				
				14,400*	14,400*

* Decrease.

To bring the balances obtained by Method 2 into agreement with those which would have been obtained by using Method 1, the parent company could make the following adjustment:

Surplus.....	14,400 00	
Investment in Company S.....		14,400 00
To adjust our accounts by taking up 90% of the decrease in the subsidiary's surplus since the date of acquisition.		

Summary.—The foregoing illustrations show that, if the parent company follows the second method of accounting, the balances in its Investment and Surplus accounts can be adjusted to agree with the balances which would have been obtained under the first method, by applying the following simple rule:

- (1) Determine the amount of the increase or decrease in the subsidiary's surplus since the date of acquisition by the parent company.
- (2) Multiply this increase or decrease by the parent company's per cent of stock ownership, to determine the portion of the increase or decrease in subsidiary surplus applicable to the stock owned by the parent company.
- (3) If the subsidiary surplus has increased, debit the Investment account and credit the parent company's Surplus account for the amount determined in (2).
- (4) If the subsidiary surplus has decreased, debit the parent company's Surplus and credit the Investment account for the amount of the decrease determined in (2).

Preparing the consolidated balance sheet.—If the parent company has carried its investment at cost and has taken up subsidiary dividends as income, a consolidated balance sheet may be prepared by the following procedure:

- (1) In the working papers, adjust the parent company's Investment and Surplus accounts by making the debit and credit entries described above in paragraph (3) or (4).

- (2) As the adjusted balances of the Investment and Surplus accounts will then be the same as they would have been if the first method of accounting had been followed, a consolidated balance sheet may be prepared by the methods already described.

Several illustrations are given in the remaining sections of this chapter. The balance sheets of the parent and subsidiary companies are shown in the first two columns of the working papers. In all cases it is assumed that:

- (1) The subsidiary had a capital stock of \$100,000.00 and a surplus of \$50,000.00 on January 1, 1934, when the parent company acquired its stock.
- (2) The investment is carried at cost on the parent company's books.
- (3) The parent company has a surplus of \$30,000.00 from its own operations, and has taken up as income (and included in its surplus) the dividends received from the subsidiary.

First illustration.—The parent company purchased all of the subsidiary stock at book value, \$150,000.00. (No goodwill and no minority interest.) The subsidiary made a profit of \$10,000.00 during the year, and paid a dividend of \$6,000.00. Its surplus was therefore increased \$4,000.00 during the year.

Following is the consolidated balance sheet:

COMPANY P AND SUBSIDIARY S			
Consolidated Balance Sheet			
December 31, 1934			
Assets		Liabilities and Net Worth	
Cash	\$ 55,000	Accounts Payable	\$ 61,000
Accounts Receivable	145,000	Net Worth:	
Inventory	191,000	Capital Stock.	\$300,000
Goodwill	10,000	Surplus	40,000
	<u>\$401,000</u>		<u>340,000</u>
			<u>\$401,000</u>

This consolidated balance sheet could be prepared from the working papers on page 238. Note the debit and credit entries in the two Adjustment columns to adjust the parent company's Investment and Surplus accounts for the \$4,000.00 increase in the subsidiary's Surplus since acquisition.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934

	ADJUSTMENTS		Elimi- nations	Consolidated Balance Sheet
	Debit	Credit		
Assets				
Cash.....	35,000.00			55,000.00
Accounts Receivable.....	80,000.00			145,000.00
Inventory.....	111,000.00			191,000.00
Investment in Company S—100% (Cost).....	150,000.00			
Adjustment—Increase in Company S Net Assets since Acquisition.....		4,000.00		
Eliminate Book Value:				
Capital Stock.....			100,000.00	
Surplus.....			54,000.00	
Goodwill.....			<u>154,000.00</u>	<u>10,000.00</u>
	<u>376,000.00</u>			<u>401,000.00</u>
Liabilities and Net Worth				
Accounts Payable.....	40,000.00			61,000.00
Capital Stock:				
Company P.....	21,000.00			300,000.00
Company S.....	100,000.00			
Eliminate Company P's 100% Surplus:			100,000.00	
Company P.....	36,000.00			
Adjustment—Increase in Company S Surplus since Acquisition.....		4,000.00		40,000.00
Company S.....	54,000.00			
Eliminate Company P's 100% Surplus:			54,000.00	
	<u>376,000.00</u>		<u>4,000.00</u>	<u>401,000.00</u>

A consolidated balance sheet can be prepared from the foregoing working papers, or one can be prepared without formal working papers by the method described on page 224 of the preceding chapter, thus:

- (1) In the following simple working papers, adjust the parent company's Investment and Surplus accounts. Then make the customary eliminations from the Investment account and from the subsidiary's Capital Stock and Surplus accounts, to determine the amounts (if any) of goodwill and minority interest.

	SUBSIDIARY'S		PARENT'S	
	Capital Stock	Sur- plus	Invest- ment	Sur- plus
Balances before Adjustment	\$100,000	\$54,000	\$150,000	\$36,000
Add Increase in Subsidiary's Net Assets and Surplus since Date of Acquisition			4,000	4,000
Adjusted Balances			\$154,000	\$40,000
Deduct Reciprocal Element—100% . . .	100,000	54,000	154,000	
Non-Reciprocal Elements	—	—	—	

- (2) Enter in the consolidated balance sheet:
 - (a) Combined balances of asset accounts.
 - (b) Combined balances of liability accounts.
 - (c) Minority interest: none.
 - (d) Net worth: parent company's capital stock and the \$40,000.00 adjusted balance of its Surplus.

Second illustration.—The parent company purchased only 90% of the stock, leaving a 10% minority interest. The book value of the stock purchased was 90% of \$150,000.00, or \$135,000.00; the price paid was \$138,000.00; hence, there is a goodwill element of \$3,000.00. The subsidiary made a profit of \$10,000.00 during the year, and paid a dividend of \$6,000.00, thus increasing its surplus \$4,000.00. The parent company's portion of this increase in surplus was 90% of \$4,000.00, or \$3,600.00.

The consolidated balance sheet can be prepared from the working papers on page 240. Note the adjustment of the parent company's Investment and Surplus accounts for the 90% interest in the increase in the subsidiary's Surplus since acquisition.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934

	ADJUSTMENTS			
	Debit	Credit		
Assets				
Cash.....	47,000.00			67,000.00
Accounts Receivable.....	80,000.00			145,000.00
Inventory.....	111,000.00			191,000.00
Investment in Company S—90% (Cost).....	138,000.00			
Adjustment—90% of Increase in Company S Net Assets since Acquisition.....	3,600.00			
Eliminate Book Value:				
Capital Stock—90%.....			90,000.00	
Surplus—90%.....			48,600.00	3,000.00G
Goodwill.....				10,000.00G
24 Goodwill.....			<u>138,600.00</u>	<u>416,000.00</u>
Liabilities and Net Worth				
Accounts Payable.....	40,000.00			61,000.00
Capital Stock:	<u>376,000.00</u>			
Company P.....	21,000.00			
Company S.....	100,000.00			300,000.00
Eliminate Company P's 90%.....			90,000.00	
Minority Interest—10%.....				10,000.00M
Surplus:				
Company P.....	36,000.00			
Adjustment—90% of Increase in Company S Surplus since Acquisition.....		3,600.00		39,600.00
Company S.....	54,000.00			
Eliminate Company P's 90%.....			48,600.00	5,400.00M
Minority Interest—10%.....				1,000.00M
	<u>376,000.00</u>	<u>3,600.00</u>	<u>3,600.00</u>	<u>416,000.00</u>

The consolidated balance sheet may be prepared without formal working papers thus:

- (1) Adjust the parent company's Investment and Surplus accounts, and determine the minority interest and goodwill.

	SUBSIDIARY'S		PARENT'S	
	Capital Stock	Sur- plus	Invest- ment	Sur- plus
Balances before Adjustment.....	\$100,000	\$54,000	\$138,000	\$36,000
Add 90% of \$4,000 Increase in Subsidiary Surplus since Acquisition.....			3,600	3,600
Adjusted Balances			\$141,600	\$39,600
Deduct Reciprocal Elements—90%....	90,000	48,600	138,600	
Non-Reciprocal Elements:				
Minority Interest—10%.....	\$ 10,000	\$ 5,400		
Goodwill.....			\$ 3,000	

- (2) Enter in the consolidated balance sheet:
 - (a) Combined balances of asset accounts; add the \$3,000 goodwill adjustment to the goodwill in the balance sheet of Company S.
 - (b) Combined balances of liability accounts.
 - (c) Minority interest of \$15,400.00, as determined in (1).
 - (d) Net worth: parent company's capital stock and the \$39,600.00 adjusted balance of its Surplus account.

Following is the consolidated balance sheet:

COMPANY P AND SUBSIDIARY S			
Consolidated Balance Sheet			
December 31, 1934			
Assets		Liabilities and Net Worth	
Cash.....	\$ 67,000	Accounts Payable.....	\$ 61,000
Accounts Receivable.....	145,000	Minority Int. in Co. S—10%	15,400
Inventory.....	191,000	Net Worth:	
Goodwill.....	13,000	Capital Stock..	\$300,000
		Surplus.....	39,600
	\$416,000		\$416,000

Third illustration.—The parent company purchased a 90% interest in the subsidiary stock. The book value of the stock was \$135,000.00, and the purchase price was \$138,000.00. During 1934, the subsidiary lost \$10,000.00 and paid a

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934

	Company P	Company S	ADJUSTMENTS	Eliminations	Consolidated Balance Sheet
			Debit	Credit	
Assets					
Cash	47,000.00	20,000.00			67,000.00
Accounts Receivable	80,000.00	65,000.00			145,000.00
Inventory	111,000.00	80,000.00			191,000.00
Investment in Company S—90% (Cost)	138,000.00				
Adjustment—90% of \$16,000 Decrease in Subsidiary Net Assets since Acquisition			14,400.00		
Eliminate Book Value:					
Capital Stock—90%		10,000.00		90,000.00	3,000.00G
Surplus—90% of \$34,000		175,000.00		30,600.00	10,000.00G
Goodwill	376,000.00				120,600.00
Goodwill					416,000.00
	40,000.00	41,000.00			81,000.00
Liabilities and Net Worth					
Accounts Payable					300,000.00
Capital Stock:					
Company P	300,000.00				
Company S		100,000.00			
Eliminate Company P's 90%				90,000.00	
Minority Interest—10%					10,000.00M
Surplus:					
Company P	36,000.00				
Adjustment—90% of \$16,000 Decrease in Subsidiary Surplus since Acquisition			14,400.00		
Company S		34,000.00			
Eliminate Company P's 90%				30,600.00	
Minority Interest—10%					3,400.00M
	376,000.00	175,000.00	14,400.00	14,400.00	416,000.00

\$6,000.00 dividend, thus decreasing its surplus \$16,000.00. The parent company's portion of this decrease was 90% of \$16,000.00, or \$14,400.00.

The consolidated balance sheet may be prepared without formal working papers thus:

- (1) Adjust the parent company's Investment and Surplus accounts and determine the minority interest and goodwill.

	<u>SUBSIDIARY'S</u>		<u>PARENT'S</u>	
	<u>Capital</u>	<u>Sur-</u>	<u>Invest-</u>	<u>Sur-</u>
	<u>Stock</u>	<u>plus</u>	<u>ment</u>	<u>plus</u>
Balances before Adjustment.....	\$100,000	\$34,000	\$138,000	\$36,000
Deduct 90% of \$16,000 Decrease in Sub-				
sidiary Surplus since Acquisition....			14,400	14,400
Adjusted Balances.....			<u>\$123,600</u>	<u>\$21,600</u>
Deduct Reciprocal Elements—90%....	<u>90,000</u>	<u>30,600</u>	<u>120,600</u>	
Non-Reciprocal Elements:				
Minority Interest—10%.....	\$ 10,000	\$ 3,400		
Goodwill.....			<u>\$ 3,000</u>	

- (2) Enter in the consolidated balance sheet:
 - (a) Combined balances of asset accounts; add the \$3,000.00 goodwill element to the goodwill in the balance sheet of Company S.
 - (b) Combined balances of liability accounts.
 - (c) Minority interest of \$13,400.00, as determined in (1).
 - (d) Net worth: parent company's capital stock and adjusted surplus of \$21,600.00.

Following is the consolidated balance sheet, which could be prepared from the working papers on page 242, or by the method just described.

COMPANY P AND SUBSIDIARY S

Consolidated Balance Sheet

December 31, 1934

<u>Assets</u>		<u>Liabilities and Net Worth</u>	
Cash.....	\$ 67,000	Accounts Payable.....	\$ 81,000
Accounts Receivable.....	145,000	Minority Int. in Co. S—10%	13,400
Inventory.....	191,000	Net Worth:	
Goodwill.....	13,000	Capital Stock..	\$300,000
		Surplus.....	<u>21,600</u>
	<u>\$416,000</u>		<u>\$416,000</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934

	Company P	Company S	ADJUSTMENTS	Elimina- tions	Consolidated Balance Sheet
			Debit	Credit	
Assets					
Cash.....	54,000.00	20,000.00			74,000.00
Accounts Receivable.....	80,000.00	65,000.00			145,000.00
Inventory.....	111,000.00	80,000.00			191,000.00
Investment in Company S—90% (Cost).....	131,000.00				
Adjustment—90% of \$16,000 Decrease in Sub- sidiary Net Assets since Acquisition.....			14,400.00		
Eliminate Book Value:					
Capital Stock—90%.....				90,000.00	4,000.00*G
Surplus—90% of \$34,000.....				30,600.00	10,000.00G
Deduction from Goodwill.....				120,600.00	416,000.00
Goodwill.....	<u>376,000.00</u>	<u>10,000.00</u>			<u>4,000.00*G</u>
		<u>175,000.00</u>			<u>10,000.00G</u>
	40,000.00	41,000.00			81,000.00
Liabilities and Net Worth					
Accounts Payable.....					
Capital Stock:					
Company P.....	300,000.00				300,000.00
Company S.....		100,000.00			
Eliminate Company P's 90%.....				90,000.00	
Minority Interest—10%.....					10,000.00M
Surplus:					
Company P.....	36,000.00				
Adjustment—90% of \$16,000 Decrease in Subsidiary Surplus since Acquisition.....			14,400.00		
Company S.....		34,000.00			21,600.00
Eliminate Company P's 90%.....				30,600.00	
Minority Interest—10%.....					3,400.00M
	<u>376,000.00</u>	<u>175,000.00</u>	<u>14,400.00</u>	<u>14,400.00</u>	<u>416,000.00</u>

Fourth illustration.—The parent company purchased a 90% interest in the subsidiary; the book value of the stock was \$135,000.00, and the purchase price was \$131,000.00; thus, there is a negative goodwill element of \$4,000.00. During the year, the subsidiary lost \$10,000.00, and paid a dividend of \$6,000.00.

The consolidated balance sheet may be prepared from the working papers on page 244; or without them, thus:

- (1) Adjust the parent company's Investment and Surplus accounts, and determine the minority interest and the goodwill.

	SUBSIDIARY'S		PARENT'S	
	Capital Stock	Sur- plus	Invest- ment	Sur- plus
Balances before Adjustment.....	\$100,000	\$34,000	\$131,000	\$36,000
Deduct 90% of \$16,000 Decrease in Subsidiary Surplus since Acquisition			14,400	14,400
Adjusted Balances.....			\$116,600	\$21,600
Deduct Reciprocal Elements—90%...	90,000	30,600	120,600	
Non-Reciprocal Elements:				
Minority Interest—10%	\$ 10,000	\$ 3,400		
Deduction from Goodwill			\$ 4,000*	

- (2) Enter in the consolidated balance sheet:
- (a) Combined balances of asset accounts; deduct the \$4,000.00 negative goodwill item from the \$10,000.00 goodwill shown in the balance sheet of Company S.
 - (b) Combined balances of liability accounts.
 - (c) Minority interest of \$13,400.00.
 - (d) Net worth: parent company's capital stock and adjusted surplus of \$21,600.00.

Following is the consolidated balance sheet:

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet
December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 74,000	Accounts Payable.....	\$ 81,000
Accounts Receivable.....	145,000	Minority Int. in Co. S—10%	13,400
Inventory.....	191,000	Net Worth:	
Goodwill.....	6,000	Capital Stock..	\$300,000
		Surplus.....	21,600
	<u>\$416,000</u>		<u>321,600</u>
			<u>\$416,000</u>

CHAPTER 46

PARENT AND SUBSIDIARY ACCOUNTING (Continued) INTERCOMPANY ACCOUNTS

Intercompany notes discounted.—The elimination of intercompany accounts receivable and payable and intercompany notes receivable and payable has been illustrated. The situation is more complex when one company has discounted notes receivable taken from a related company. To illustrate, assume that Company *A* has given a \$5,000.00 note to Company *B*. Company *B* has discounted this note with its bankers. At the date of the consolidated balance sheet, the note has not matured.

Since the note is in the hands of the bankers, the liability is no longer an intercompany one, and hence it must be shown as a liability on the consolidated balance sheet. The Notes Payable account on Company *A*'s books should be offset in the working papers against the Notes Receivable account on Company *B*'s books, and the Notes Receivable—Company *A*—Discounted account should be carried to the Consolidated Balance Sheet column, thus:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Elimina- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Notes Receivable—Co. <i>A</i>		5,000	5,000	
Liabilities				
Notes Payable—Co. <i>B</i>	5,000		5,000	
Notes Rec.—Co. <i>A</i> —Discounted....		5,000		5,000

There is a difference of opinion among accountants as to whether the \$5,000.00 liability to outsiders should be shown in the consolidated balance sheet as Notes Receivable—Company *A*—Discounted, or as Notes Payable. Those who favor the former title contend that the note is a direct liability of one of the related companies and a secondary liability of the other company, and hence is an obligation different in

nature from a note signed by one company only. Showing the liability as a note payable would not indicate the liability of both companies.

The author's opinion is that the Notes Payable title is preferable. In the first place, the consolidated balance sheet is based on the assumption that the related companies are a single organization, and the legal fact of separate corporate entities is ignored. From the viewpoint of the consolidated balance sheet, therefore, a note signed by one company is as much a liability of the organization as a note signed by one company and indorsed by another related company. In the second place, the term Notes Receivable Discounted at once suggests a contingent liability, and since an intercompany note discounted with an outsider is a positive liability, the term is likely to be misleading.

Customers' notes transferred.—If one of the related companies discounts its customers' notes at the bank, no peculiar difficulties arise. Its accounts will contain, for example, the following balances:

Notes Receivable.....	\$20,000.00	
Notes Receivable Discounted.....		\$5,000.00

The consolidated balance sheet will include the \$15,000.00 of undiscounted notes, and the \$5,000.00 contingent liability on discounted notes will be mentioned in a footnote.

If Company *A* transferred the \$5,000.00 of customers' notes to Company *B*, an affiliated company, the accounts of the two companies might contain the following balances:

<u>Company A's Books</u>		
Notes Receivable.....	\$20,000.00	
Notes Receivable Discounted.....		\$5,000.00
<u>Company B's Books</u>		
Notes Receivable.....	\$ 5,000.00	

Since the \$5,000.00 of discounted notes are carried in the Notes Receivable accounts of both companies, and since the \$5,000.00 credit to Notes Receivable Discounted does not represent a contingent liability to outsiders, \$5,000.00 of the Notes Receivable balance and the total Notes Receivable Discounted credit balance should be eliminated.

But suppose that Company *B* has rediscounted \$3,000.00 of the notes at the bank. The account balances and the eliminations in the working papers will be as follows:

	Com- pany <i>A</i>	Com- pany <i>B</i>	Elimina- tions	Consoli- dated Balance Sheet
Assets				
Notes Receivable.....	20,000	5,000	5,000	20,000
Liabilities				
Notes Receivable Discounted.....	5,000	3,000	5,000	3,000

The \$5,000.00 contingent liability on the books of Company *A* should be eliminated, with an offsetting elimination against the Notes Receivable on the books of Company *B*. The \$3,000.00 contingent liability to outsiders, shown by the books of Company *B*, should be extended to the Consolidated column so that it will not be overlooked when preparing the consolidated balance sheet; the balance sheet should show as an asset the \$17,000.00 of notes not discounted with outsiders, and the contingent liability of \$3,000.00 to outsiders should be mentioned in a footnote.

Intercompany bond holdings.—When one company holds bonds of a related company, the bonds held as an asset by one company are sometimes offset against the bond liability of the other company, and only the net amount outstanding in the hands of the public is shown as a liability. It is preferable, however, to carry out the balance of the asset account and the balance of the liability account to the balance sheet columns of the working papers, and deduct the intercompany holdings from the total liability in the consolidated balance sheet.

The situation is somewhat analogous to that of a corporation with an authorized bond issue of, say, \$500,000.00, of which only \$400,000.00 has been issued; such facts should be shown on the balance sheet thus:

Bonds Payable—Authorized.....	\$500,000.00	
Less Treasury Bonds.....	100,000.00	
Bonds Outstanding.....		\$400,000.00

This procedure is followed because the mortgage is security for the full issue of \$500,000.00, and the company has \$100,000.00 of bonds available for issuance or for use as collateral

for short-term loans on notes payable.

Similarly, in the case of intercompany bond holdings, the bonds are virtually treasury bonds of the organization, available for issuance or for use as collateral.

Premium or discount on intercompany bond holdings.— If the company which purchased the bonds paid more or less than par for them, it may have written off the premium or discount immediately. From the individual company standpoint, it is better to charge the Bond Investment account with the purchase cost and to amortize the premium or discount. From the consolidated standpoint, the premium or discount on issuance by one company and the premium or discount on repurchases by another related company should probably be disposed of as they would be if the bonds were issued and retired by the same company.

To illustrate, assume that Company *B* issued bonds of a par value of \$100,000.00 at a discount of \$2,000.00, and that Company *A* acquired \$10,000.00 of the bonds at a discount of \$150.00, before any of the discount had been amortized by Company *B*. In the consolidated working papers, the cost of the bonds acquired may be detailed, the discount on purchase may be offset against the discount on sale applicable thereto, and the net discount applicable to the reacquired bonds may be written off against the parent company's surplus, as illustrated below:

	Com- pany <i>A</i>	Com- pany <i>B</i>	ADJUSTMENTS		Con- sol- dated
			Debit	Credit	
Assets					
Bonds of Company <i>B</i> —Par.....	10,000				10,000
Discount on Purchase.....	150*		150		
Discount on Issuance of Bonds..		2,000		200	1,800
Liabilities					
Bonds Payable.....		100,000			100,000
Surplus—Company <i>A</i>	5,000		50		4,950

* Red.

The adjusting entry writes off \$200.00 (or one tenth of the discount on issuance), as applicable to the 10% portion of the bonds reacquired; it also writes off the \$150.00 discount on repurchase; and it charges the difference, \$50.00, to surplus of the parent company so as to deduct it from the consolidated surplus.

It should be recognized that such an adjustment is con-

servative if it results in a net debit to surplus; but it would not be so conservative if the discount on purchase was greater than the discount on issuance, so that the adjustment involved a net credit to surplus. In such a case, it would be more conservative, but perhaps not obligatory, to include the net credit as a deferred credit in the consolidated balance sheet.

A theoretical objection may be raised against the illustrated treatment if the parent company does not own 100% of the stock of the company which issued the bonds and of the company which reacquired them. To present a simple case, assume that Company A owns 75% of the stock of Company B and 90% of the stock of Company C. Company B issued \$100,000.00 of bonds at a discount and Company C acquired, at a discount of \$4,000.00, all of these bonds at a date when Company B was still carrying \$5,000.00 of unamortized discount. The elimination of the discounts by the method illustrated above would result as follows:

	Com- pany <u>A</u>	Com- pany <u>B</u>	Com- pany <u>C</u>	ADJUSTMENTS		Consoli- dated Balance Sheet
				Debit	Credit	
Assets						
Bonds of Co. B—Par . .			100,000			100,000
Discount on Purchase of Bonds.			4,000*	4,000		
Discount on Issuance of Bonds.		5,000			5,000	
Liabilities						
Bonds Payable.		100,000				100,000
Surplus.	25,000			1,000		24,000

* Red.

The \$1,000.00 charge against the Surplus of Company A is theoretically incorrect because it ignores the minority interests in Companies B and C. The gradual amortization of the discounts would affect the consolidated Surplus (or Surplus of Company A) and the minority interests as follows:

	Total	Surplus of Com- pany A	Minority Interests
Discount on Issuance—75% to Company A and 25% to Minority of B.	\$5,000	\$3,750	\$1,250
Discount on Repurchase—90% to Company A and 10% to Minority of C.	4,000	3,600	400
Net Charges to Surplus and to Minority. . .	<u>\$1,000</u>	<u>\$ 150</u>	<u>\$ 850</u>

Greater accuracy would therefore result from an adjustment charging the Surplus of Company A with only the \$150.00 by which its surplus will ultimately be reduced.

The \$850.00 difference between the \$1,250.00 debit and the \$400.00 credit carried to the Consolidated Balance Sheet column, would be shown in the consolidated balance sheet as unamortized discount. The facts would be shown in the consolidated working papers in the manner illustrated below:

	Com- pany <u>A</u>	Com- pany <u>B</u>	Com- pany <u>C</u>	ADJUSTMENTS		Consoli- dated Balance Sheet
				Debit	Credit	
Assets						
Bonds Owned—Par.....			100,000			100,000
Discount on Purchase...			4,000*	3,600		400*
Discount on Issuance...		5,000			3,750	1,250
Liabilities						
Bonds Payable.....		100,000				100,000
Surplus.....	25,000			150		24,850

* Red.

By this treatment, the following balance sheet shows (in this particular case) unamortized bond discount although no bonds are shown as outstanding.

Assets	
Deferred Charge:	
Unamortized Discount on Purchase of Treasury Bonds.....	\$850.00
Liabilities and Net Worth	
Fixed Liabilities:	
Bonds Payable—Company B.....	\$100,000.00
Less Intercompany-Owned Bonds.....	<u>100,000.00</u>
Outstanding.....	—

Accrued interest.—If there are intercompany bonds or notes, the balance sheet of the company issuing the paper may show a liability for accrued interest. The company holding the paper should then show an asset of accrued interest receivable. The accrued interest receivable should be offset against the accrued interest payable, and only the net amount due to the outside creditors should be shown as a liability on the consolidated balance sheet.

Declared dividends unpaid.—If the subsidiary has declared dividends which are unpaid at the date of the balance sheet,

its books will show a liability of dividends payable. The parent company's books should show an asset of dividends receivable, which should be offset against the dividends payable. The consolidated balance sheet will then show only the liability for dividends declared and payable to the outside, or minority, stockholders.

Adjusting intercompany accounts.—All intercompany relations should be shown on the books of both related companies, so that the same amounts may be eliminated from the assets and the liabilities. If any intercompany transactions have been recorded on the books of one company only, they should be taken up on the books of the other company before the consolidated balance sheet is prepared.

Goods may have been sold by one company to another immediately prior to the close of the year and recorded in the current account of the selling company, but not taken up on the books of the purchasing company. Before the consolidated balance sheet is prepared, these goods should be added to the purchasing company's inventory and credited to its current account with the selling company.

If services have been rendered by one company and recorded by a charge to the current account and by a credit to income, and if the balance sheet of the other company was drawn up before the transaction was recorded, an adjustment should be made debiting Surplus and crediting the current account of the company rendering the service.

If a company holding bonds of a related company, has not taken up its share of the accrued interest on these bonds, an adjustment should be made debiting Bond Interest Receivable and crediting Surplus.

If the subsidiary has declared a dividend which is unpaid at the date of the balance sheet and which is shown on its books as Dividends Payable, the holding company should take up its share by a debit to Dividends Receivable. The offsetting credit will depend upon the method adopted by the parent company for carrying its investment in the subsidiary stock. If it has taken up its share of subsidiary profits and losses, the offsetting credit for the dividend will be made in the Investment account. If the investment is carried at cost, the offsetting credit will be made to Surplus.

All of these adjustments may be entered in the Adjustment columns in the consolidated working papers.

Illustration.—Company *A* owns 90% of the stock of Company *B* and 95% of the stock of Company *C*. Company *A* has taken up its share of the profits and losses of Company *B*, but is carrying its investment in Company *C* at cost. The balance sheets on December 31, 1933, appear in the working papers on pages 256 and 257. The adjustments and eliminations in the working papers are described below.

Adjustment A.—Company *A* acts as a selling agent for Company *B* on a commission basis. On December 31, 1933, Company *A* charged Company *B* \$1,000.00 as commission on sales made during December, but this commission expense and liability have not been taken up on the books of Company *B*. Adjustment *A*, for \$1,000.00, debits the Surplus account of Company *B* and credits Company *B*'s current account with Company *A*.

Adjustment B.—Company *A* has taken up its 90% interest in the profits of Company *B* for 1933, by a debit to Investment in Stock of Company *B* and a credit to Surplus. Company *B*'s failure to record the \$1,000.00 commission charge resulted in a \$1,000.00 overstatement of Company *B*'s profit. The 90% portion of Company *B*'s profit taken up by Company *A* was therefore overstated \$900.00. This overstatement is corrected by Adjustment *B*, which debits the Surplus of Company *A* and credits Investment in Stock of Company *B*, \$900.00.

Adjustment C.—On December 30, 1933, Company *B* drew a draft on Company *A* for \$3,000.00 and deposited the proceeds. Company *B* debited Cash and credited Company *A*. The draft was not presented to Company *A* until January 1934, and the transaction was not recorded by Company *A* before drawing up its balance sheet. Adjustment *C*, applicable to the accounts of Company *A*, debits the current account of Company *B* and credits Cash, \$3,000.00.

Adjustment D.—Company *B* has declared a dividend of \$3,000.00, of which amount \$2,700.00 represents Company *A*'s 90%. The dividend liability is shown in the balance sheet of Company *B*, but the dividend receivable has not been taken up on the books of Company *A*. Adjustment *D* debits Dividends Receivable, \$2,700.00; since Company *A* has recorded the profits, losses, and past dividends of Company *B* through the Investment account, the offsetting credit of \$2,700.00 is made in the Investment account.

Adjustment E.—Company *C* has declared a dividend of \$2,000.00, of which amount Company *A*'s 95%, or \$1,900.00, has not been taken up on its books; Adjustment *E* debits Dividends Receivable, \$1,900.00. Since the parent company is carrying its investment in Company *C* at cost and regards dividends as income, this dividend is taken up by a credit to Company *A*'s Surplus.

Adjustment F.—Company *A* owns \$40,000.00 par value of bonds issued by Company *B*; the accrued interest, \$1,200.00 (at 6% per annum for six months), has not been taken up on Company *A*'s books. This adjustment debits Bond Interest Receivable and credits Company *A*'s Surplus, \$1,200.00.

Adjustment G.—The \$40,000.00 par value of bonds owned are carried at \$41,000.00; this latter amount includes \$1,000.00 of unamortized premium on purchase. The balance sheet of Company *B* shows \$2,000.00 of unamortized premium applicable to the total issue of \$50,000.00 of bonds. Since Company *A* owns only 90% of the stock of Company *B* and 80% of its bonds, the adjustment of the two premium accounts is made as follows:

Unamortized Premium on Issuance (Books of Company <i>B</i>).....	1,440.00
(\$1,440 is 90% of 80% of the \$2,000 balance in the Premium account on <i>B</i> 's books)	
Unamortized Premium (Books of Co. <i>A</i>)...	1,000 00
Surplus of Company <i>A</i>	440.00

Adjustment H.—Company *A* is carrying its investment in Company *C* at cost. Company *C* had a surplus of \$30,000.00 on the date at which its stock was acquired by Company *A*. Company *C*'s surplus on December 31, 1933, is \$18,000.00. Company *A*'s 95% of the \$12,000.00 decrease, or \$11,400.00, should be debited to Company *A*'s Surplus and credited to its Investment in the Stock of Company *C*.

Eliminations a and b.—Ninety per cent of Company *B*'s capital stock and 90% of its surplus (as adjusted) on December 31, 1933, are eliminated from the parent company's Investment account and from the subsidiary's Stock and Surplus accounts: \$45,000.00 from Capital Stock and \$13,950.00 from Surplus.

Eliminations c and d.—Ninety-five per cent of Company *C*'s capital stock and 95% of its surplus are eliminated from the parent company's Investment account and from the subsidiary's Capital Stock and Surplus accounts: \$38,000.00 from Capital Stock and \$17,100.00 from Surplus.

Elimination e.—Intercompany current accounts of Companies
(Continued on page 258.)

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Balance Sheet Working Papers
December 31, 1933

	Com- pany A	Com- pany B	Com- pany C	ADJUSTMENTS	Elimi- nations	Consolidated Balance Sheet
				Debit	Credit	
Assets						
Investment in Stock of Company B—90%.....	64,000			900(B)		
Overstatement of B's Profit.....				2,700(D)		
Dividends Declared by Company B.....					45,000(a)	
Eliminate Book Value:					13,950(b)	1,450(G)
Capital Stock—90% of \$50,000.....						
Surplus (as adjusted) 90% of \$15,500.....						
Goodwill.....						
Investment in Stock of Company C—95% (at cost).....	68,000					
Adjustment—95% of Decrease in Company C Surplus:				11,400(H)		
Surplus at Acquisition.....	30,000					
Present Surplus.....	18,000					
95% of Decrease.....	<u>12,000</u>					
Eliminate Book Value:					38,000(e)	
Capital Stock—95% of \$40,000.....					17,100(d)	1,500(G)
Surplus—95% of \$18,000.....						25,000
Goodwill.....						
Cash.....	5,000		3,000	3,000(C)	9,000(e)	
Company B Current.....	6,000				10,000(f)	
Advances to Company C.....	10,000					
Investment in Bonds of Company B:						
Par of Bonds.....	40,000					40,000
Unamortised Premium.....	1,000					
Merchandise Inventory.....		40,000				102,000
Notes Receivable.....		15,000				11,000
Notes Receivable—Company C.....		75,000	14,000		15,000(g)	89,000
Plant.....						
Dividends Receivable:.....				2,700(D)	2,700(i)	
Company B Stock—90% of \$3,000.....					1,900(j)	
Company C Stock—95% of \$2,000.....					1,200(h)	
Bond Interest Receivable (on \$40,000 Company B Bonds).....					<u>153,850</u>	<u>269,950</u>
	<u>194,000</u>	<u>150,000</u>	<u>90,000</u>			

Liabilities and Net Worth						
Accounts Payable.....	25,000	13,000	5,000	1,000(A)	1,200(b)	43,000
Bond Interest Accrued.....		1,500			9,000(e)	300
Company A Current.....		8,000				6,000
Notes Receivable—Company C—Discounted.....		6,000				300
Dividends Payable:						100
Company B.....		3,000			2,700(i)	1,900(j)
Company C.....			2,000		1,900(j)	100
Advances from Company A.....			10,000		10,000(k)	
Notes Payable—Company B.....			15,000		15,000(l)	
Bonds Payable.....		50,000				50,000
Unamortized Premium on Bonds.....		2,000		1,440(G)		560
Capital Stock:						
Company A.....						100,000
Company B.....	100,000					
Eliminate Company A's 90%.....		50,000			45,000(a)	5,000(M)
Minority Interest—10%.....			40,000			
Company C.....						
Eliminate Company A's 95%.....					38,000(c)	
Minority Interest—5%.....						2,000(M)
Surplus:						
Company A.....	69,000					
Deduct 90% of Overstatement of Company B's Profit.....				900(B)		
Add Dividends on Company C Stock.....					1,900(E)	
Add Bond Interest Accrued.....					1,200(F)	
Deduct 95% of Decrease in Company C Surplus Since Acquisition.....				11,400(H)		
Add Bond Premium Adjustment.....					440(G)	
Adjusted Balance.....		16,500				60,240(S)
Company B.....						
Deduct Commissions.....				1,000(A)		
Eliminate Company A's 90% of \$15,500.....						1,550(M)
Minority Interest—10%.....			18,000			
Company C.....						
Eliminate Company A's 95%.....					17,100(d)	
Minority Interest—5%.....						900(M)
	<u>194,000</u>	<u>150,000</u>	<u>90,000</u>	<u>23,540</u>	<u>23,540</u>	<u>153,850</u>
						<u>269,950</u>

A and B, \$9,000.00.

Elimination f.—Advance from Company A to Company C, \$10,000.00.

Elimination g.—Company B has received \$15,000.00 of notes from Company C. The intercompany Notes Receivable and Notes Payable accounts are eliminated; \$6,000.00 of the notes have been discounted with outsiders, as shown by the credit balance of the Notes Receivable Discounted account, which is extended to the Consolidated column.

Elimination h.—Accrued bond interest, \$1,200.00, payable by Company B to Company A.

Eliminations i and j.—Intercompany dividends.

The consolidated balance sheet appears below.

COMPANY A AND SUBSIDIARY COMPANIES B AND C
Consolidated Balance Sheet
December 31, 1933

Assets		
Current Assets:		
Cash.....	\$ 25,000.00	
Notes Receivable.....	11,000.00	
Merchandise Inventory.....	102,000.00	\$138,000.00
Fixed Assets:		
Plant.....	\$ 89,000.00	
Goodwill.....	2,950.00	91,950.00
		\$229,950.00
Liabilities and Net Worth		
Current Liabilities:		
Accounts Payable.....	\$ 43,000.00	
Notes Payable.....	6,000.00	
Accrued Bond Interest.....	300.00	
Dividends Payable.....	400.00	\$ 49,700.00
Fixed Liabilities:		
Bonds Payable.....	\$ 50,000.00	
Less Treasury Bonds.....	40,000.00	10,000.00
Unamortized Bond Premium.....		560.00
Minority Interests:		
Company B—10%.....	\$ 6,550.00	
Company C—5%.....	2,900.00	9,450.00
Net Worth:		
Capital Stock.....	\$100,000.00	
Surplus.....	60,240.00	160,240.00
		\$229,950.00

Minority column in working papers.—If there are a number of subsidiaries, the liability and net worth section of the working papers may be somewhat simplified by including a Minority column, as illustrated on page 259.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Balance Sheet Working Papers—(Continued)
December 31, 1933

Liabilities and Net Worth	Com- pany A	Com- pany B	Com- pany C	ADJUSTMENTS		Elimina- tions	Mi- nority	Consolidated Balance Sheet
				Debit	Credit			
Adjustment column totals forward.....				8,800	19,000			
Accounts Payable.....	25,000	13,000	5,000			1,200(h)		43,000
Bond Interest Accrued.....		1,500				9,000(e)		300
Company A Current.....		8,000			1,000(A)			6,000
Notes Receivable—Company C—Discounted. . .		6,000						
Dividends Payable:								
Company B.....		3,000				2,700(i)		300
Company C.....			2,000			1,900(j)		100
Advances from Company A.....			10,000			10,000(f)		
Notes Payable—Company B.....			15,000			15,000(g)		
Bonds Payable.....	50,000							50,000
Unamortised Premium on Bonds.....		2,000		1,440(G)				560
Capital Stock:								
Company A.....	100,000							100,000
Company B.....		50,000				45,000(a)	5,000(B)	
Company C.....			40,000			38,000(c)	2,000(C)	
Surplus:								
Company A.....	69,000							
Deduct 90% of Overstatement in Co. B Profit				900(B)				
Add Dividends on Company C Stock. . .					1,900(E)			
Add Bond Interest Accrued.....					1,200(F)			
Deduct 95% of Decrease in Company C Sur- plus Since Acquisition.....				11,400(H)				
Add Bond Premium Adjustment.....					440(G)			
Adjusted Balance.....		16,500	18,000	1,000(A)		13,950(b)	1,550(B)	60,240(S)
Company B.....						17,100(d)	900(C)	
Company C.....							9,450	9,450(M)
Total Minority Interest.....						153,850		269,960
	<u>194,000</u>	<u>150,000</u>	<u>90,000</u>	<u>23,540</u>	<u>23,540</u>			

CHAPTER 47

PARENT AND SUBSIDIARY ACCOUNTING (Concluded) MISCELLANEOUS TOPICS

Minority interest; subsidiary deficit.—In all working papers thus far prepared, the minority interest has been shown at an amount equal to the minority's share of the subsidiary's stock plus its share of the subsidiary's surplus, or minus its share of the subsidiary's deficit, at the date of the consolidated balance sheet; in other words, the minority interest has been shown at the book value of the minority stock. This treatment is shown by the following illustration, in which it is assumed that the parent company has taken up its share of subsidiary gains and losses; the minority interest is reduced by its share of the subsidiary's deficit.

	<u>Com- pany <i>P</i></u>	<u>Com- pany <i>S</i></u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Co. <i>S</i> (90%)..	38,000			
Eliminate Book Value:				
Capital Stock—90 % of \$50,000.00			45,000	
Deficit—90 % of \$10,000.00.....			9,000*	
Goodwill.....				2,000G
Cash.....	22,000	20,000		42,000
Merchandise.....	80,000	45,000		125,000
	<u>140,000</u>	<u>65,000</u>	<u>36,000</u>	<u>169,000</u>
Liabilities				
Accounts Payable.....	15,000	25,000		40,000
Capital Stock:				
Company <i>P</i>	100,000			100,000
Company <i>S</i>		50,000		
Eliminate 90 %.....			45,000	
Minority—10 %.....				5,000M
Surplus (Deficit*):				
Company <i>P</i>	25,000			25,000S
Company <i>S</i>		10,000*		
Eliminate 90 %.....			9,000*	
Minority—10 %.....				1,000*M
	<u>140,000</u>	<u>65,000</u>	<u>36,000</u>	<u>169,000</u>

Some accountants would show the minority interest at the par of the stock, without deducting the minority's pro-rata share of the deficit.

. If the minority's interest is not to be diminished by its \$1,000.00 share of the subsidiary's deficit, the \$1,000.00 shown in the foregoing working papers as a deduction from the minority's interest would be deducted from the parent company's surplus; as a result, the minority interest would be shown at \$5,000.00, the par of the stock held by the minority, and the consolidated surplus would be shown at \$24,000.00.

Accountants who follow this latter method do so on the theory that, while the minority will share in profits, the parent company will be obliged to "absorb the losses" of the subsidiary in order to hold the organization together.

Although it is true that the subsidiary may be such an essential part of the organization that the parent company will consider it expedient to retain its ownership of the stock in spite of these losses, it does not seem necessary for the parent company to assume the magnanimous position of allowing the minority stockholders to share in subsidiary profits while relieving them from any reduction in the book value of their stock caused by subsidiary losses. As long as the subsidiary is able to pay its debts, the losses merely reduce the value of all shares proportionately. If the subsidiary becomes unable to pay its debts, the parent company may advance the funds necessary to prevent the creditors from forcing the subsidiary into liquidation.

As an extreme illustration, let us assume that the subsidiary losses have resulted in a deficit equal to the capital stock, and that the parent company has not seen fit to make advances in order to keep the business out of the hands of the creditors. The creditors therefore take possession, and the parent company loses its stock and the minority stockholders lose theirs. But the parent company does not bear the minority's loss.

On the other hand, assume that the parent company has made advances, so that the subsidiary's condition is as follows:

Subsidiary Balance Sheet

Net Assets.....	\$ 50,000.00	Advances from Parent Co. \$ 50,000.00
Deficit.....	100,000.00	Capital Stock..... 100,000.00

The parent company may now take over the assets of the subsidiary in settlement of the advances; again the parent company loses its portion of the stock and the minority stockholders lose theirs.

The purpose of a balance sheet is to show the present financial condition of a business organization. It appears that a consolidated balance sheet fulfills this purpose if it shows all of the assets and liabilities of the combined companies, and the actual present interests of the parent company and of the minority stockholders in these net assets. Regardless of what the parent company may have to do in the future (and it is difficult to see how it can be obliged to bear more than its share of the loss), it cannot be denied that the present book value of the minority's interest in the net assets of the organization is measured by the minority's percentage of the subsidiary's capital stock and surplus or deficit.

Stock dividends.—To illustrate some of the problems which may arise in connection with stock dividends paid by a subsidiary, assume that Company *S* had a capital stock of \$100,000.00 and a surplus of \$50,000.00 on January 1, 1934, and that Company *P* purchased 90% of the stock on that date. The book value of the stock acquired was 90% of \$150,000.00, or \$135,000.00, and the purchase price was \$140,000.00. Hence there was a goodwill payment of \$5,000.00. During 1934, the subsidiary made a profit of \$25,000.00, and issued a stock dividend of \$40,000.00, of which Company *P* received stock of a par value of \$36,000.00. Various conditions with respect to the parent company's method of accounting may be encountered; in all cases, it will be assumed that the parent company has no surplus from its own operations.

First, assume that the parent company takes up its \$22,500.00 share of the profit of Company *S* for 1934 by a debit to the Investment account and a credit to Surplus, and that no entry is made for the stock dividend, as it represents merely a transfer of a part of the subsidiary's net worth from its Surplus account to its Capital Stock account, with no effect upon the value of Company *P*'s investment. In the author's opinion, this is the correct procedure. Eliminations will be made in the consolidated working papers as follows:

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	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S . . .	162,500			
Eliminate book value:				
Capital Stock—90% of \$140,000.00			126,000	
Surplus—90% of \$35,000.00			31,500	
Goodwill				5,000G
Liabilities				
Capital Stock—Company S		140,000	126,000	14,000M
Surplus:				
Company P	22,500			22,500S
Company S		35,000	31,500	3,500M

Note that the goodwill is \$5,000.00, the minority interest is \$17,500.00, and the consolidated surplus is \$22,500.00.

Second, let us assume that the parent company is carrying the investment at cost, and has made no entry for the stock dividend. It will be necessary to make an adjustment of Company P's Investment and Surplus accounts, by taking up its \$22,500.00 share of the profit of Company S; eliminations can then be made as in the preceding case.

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>ADJUSTMENTS</u>		<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
			<u>Debit</u>	<u>Credit</u>		
Assets						
Investment in Stock of Co. S—90%	140,000					
Add 90% of S's Net Profit since Acquisition			22,500A			
Eliminate Book Value:						
Capital Stock—90%					126,000	
Surplus—90%					31,500	
Goodwill						5,000G
Liabilities						
Capital Stock—Co. S		140,000			126,000	14,000M
Surplus:						
Company P	—					
Add 90% of Company S Profit				22,500A		22,500S
Company S		35,000			31,500	3,500M

Note that the goodwill, the minority interest, and the consolidated surplus are the same as in the preceding case.

Third, let us assume that the parent company has not taken up its \$22,500.00 portion of the profit of the subsidiary, but has taken up the stock dividend by a debit to the Investment account and a credit to Surplus. The Investment and Surplus accounts should be reduced by 90% of the excess of the stock dividend over the profits of Company S. Eliminations may then be made as shown in the following working papers:

	Com- pany <u>P</u>	Com- pany <u>S</u>	ADJUSTMENTS		Elimi- nations	Consoli- dated Balance Sheet
			Debit	Credit		
Assets						
Investment in Stock of						
Co. S.	176,000					
Adjustment:						
Stock Di- vidend. 40,000						
Profit of Co. S.	25,000					
90% of Excess. 15,000				13,500A		
Eliminate Book Value:						
Capital Stock—						
90%					126,000	
Surplus—90% . . .					31,500	
Goodwill						5,000G
Liabilities						
Capital Stock—Co. S.		140,000			126,000	14,000M
Surplus:						
Company P.	36,000					
Adjustment—as above			13,500A			
Adjusted Balance						22,500S
Company S.		35,000			31,500	3,500M

Note that the goodwill, the minority interest, and the consolidated surplus obtained are the same as those in the preceding cases.

Holdings of no-par stock.—The method of making eliminations is not affected by the fact that the subsidiary's stock is without par value. The book value of the parent company's ownings is determined by ascertaining the per cent of subsidiary stock owned, and by multiplying the subsidiary's Capital Stock and Surplus accounts by this per cent. To

illustrate, assume that the subsidiary has an issue of 3,000 shares of no-par value stock, for which \$250,000.00 was received and credited to Capital Stock. The subsidiary also has a surplus of \$60,000.00. The parent company acquires 2,400 shares at a cost of \$260,000.00.

Consolidated Working Papers

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>Elimi- nations</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company S (80 %)				
2,400 Shares of a Total Issue of 3,000	260,000			
Eliminate Book Value:				
Capital Stock—80 % of \$250,000.00. .			200,000	
Surplus—80 % of \$60,000.00.			48,000	
Goodwill.				12,000G
Liabilities				
Capital Stock—Company S.		250,000		
Eliminate Parent Company's 80 %. . .			200,000	
Minority—20 %				50,000M
Surplus—Company S.		60,000		
Eliminate Parent Company's 80 %			48,000	
Minority—20 %				12,000M

Holdings of both common and preferred stock.—When the parent company owns both common and preferred stock, it may be necessary to divide the subsidiary surplus into the portions applicable to the two classes of stock, in order to determine their book values and to make proper eliminations. In making this division, it is necessary to consider whether the subsidiary's preferred stock is cumulative or non-cumulative, and participating or non-participating, and whether there are any cumulative dividends in arrears. In the following illustrations, it is assumed that the parent company bought 80 % of the preferred stock for \$48,000.00 (par value \$40,000.00) and 90 % of the common stock for \$106,000.00 (par value \$90,000.00). The subsidiary had no surplus at the date of acquisition. The total goodwill was therefore \$8,000.00 + \$16,000.00, or \$24,000.00. At the end of one year the subsidiary had made a profit of \$18,000.00.

First, it is assumed that the preferred stock is non-cumulative and non-participating, and that the year's dividend of

\$3,000.00 has been paid on the preferred stock. The preferred therefore has no further claim on the surplus of the subsidiary, which was reduced to \$15,000.00 by the payment of the preferred dividend, and the entire \$15,000.00 is applicable to the common stock. The parent company should have taken up 90% of this amount, or \$13,500.00, as well as the \$2,400.00 dividend on its holdings of preferred stock.

Consolidated Working Papers

	Com- pany <u>P</u>	Com- pany <u>S</u>	Elimi- na- tions	Consoli- dated Balance Sheet
Assets				
Investment in Preferred Stock of Com- pany S (80%)	48,000			
Eliminate Book Value:				
Capital Stock—80% of \$50,000.00 . . .			40,000	
Goodwill				8,000G
Investment in Common Stock of Com- pany S (90%)	119,500			
Eliminate Book Value:				
Capital Stock—90% of \$100,000.00 . . .			90,000	
Surplus—90% of \$15,000.00			13,500	
Goodwill				16,000G
Liabilities and Net Worth				
Capital Stock Preferred—Company S . . .		50,000		
Eliminate Parent Company's 80%			40,000	
Minority—20%				10,000M
Capital Stock Common—Company S		100,000		
Eliminate Parent Company's 90%			90,000	
Minority—10%				10,000M
Surplus—Company S (Applicable to Com- mon Stock)		15,000		
Eliminate Parent Company's 90%			13,500	
Minority—10%				1,500M
Surplus—Company P	15,900			15,900S

Second, it is assumed that the preferred stock is cumulative and non-participating, and that there are no dividends in arrears. The rights of the preferred stockholders in the subsidiary surplus have thus been satisfied by the payment of the dividend, and the entire surplus is applicable to the common stock. Therefore the working papers would be identical with those just shown.

Third, it is assumed that the preferred stock is cumulative but non-participating, and that one year's dividend of 6% is in arrears. The surplus is therefore \$18,000.00. As the

profits have been earned, the preferred stockholders have a claim against them to the extent of \$3,000.00, and the parent company would be justified in taking up its 80% thereof by a debit to the preferred stock investment account and a credit to earnings. The subsidiary surplus is divided into two parts: \$3,000.00 applicable to preferred stock, and \$15,000.00 applicable to common stock.

Consolidated Working Papers				
	Com- pany <i>P</i>	Com- pany <i>S</i>	Elimi- na- tions	Consoli- dated Balance Sheet
Assets				
Investment in Preferred Stock of Com- pany <i>S</i> (80%).....	50,400			
Eliminate Book Value:				
Capital Stock—80% of \$50,000.00...			40,000	
Surplus—80% of \$3,000.00.....			2,400	
Goodwill.....				8,000G
Investment in Common Stock of Company <i>S</i> (90%).....	119,500			
Eliminate Book Value:				
Capital Stock—90% of \$100,000.00			90,000	
Surplus—90% of \$15,000.00.....			13,500	
Goodwill.....				16,000G
Liabilities and Net Worth				
Capital Stock—Preferred—Company <i>S</i> ..		50,000		
Eliminate Parent Company's 80%.....			40,000	
Minority—20%.....				10,000M
Capital Stock—Common—Company <i>S</i> ...		100,000		
Eliminate Parent Company's 90%.....			90,000	
Minority—10%.....				10,000M
Surplus—Company <i>S</i> (Applicable to Pre- ferred Stock).....		3,000		
Eliminate Parent Company's 80%.....			2,400	
Minority—20%.....				600M
Surplus—Company <i>S</i> (Applicable to Com- mon Stock).....		15,000		
Eliminate Parent Company's 90%.....			13,500	
Minority—10%.....				1,500M
Surplus—Company <i>P</i> (\$2,400 + \$13,500)	15,900			15,900S

Fourth, it is assumed that the preferred stock is cumulative and participating, and that no dividends have been paid on either preferred or common stock. Since the preferred stock is participating, it shares pro rata with the common stock in the surplus. Therefore \$6,000.00 of the earnings are applicable to the preferred and \$12,000.00 are applicable to the

common. The parent company would be justified in making the following entry:

Investment in Preferred Stock of Co. <i>S</i> (80 % of \$6,000.00)...	4,800
Investment in Common Stock of Co. <i>S</i> (90 % of \$12,000.00)...	10,800
Surplus.....	15,600
To take up our share of the earnings of Company <i>S</i> .	

The goodwill, minority interest, and consolidated surplus are computed below:

Consolidated Working Papers

	<u>Com- pany <i>P</i></u>	<u>Com- pany <i>S</i></u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Preferred Stock of Com- pany <i>S</i> (80 %)	52,800			
Eliminate Book Value:				
Capital Stock—80 % of \$50,000.00...			40,000	
Surplus—80 % of \$6,000.00.....			4,800	
Goodwill.....				8,000G
Investment in Common Stock of Company <i>S</i> (90 %)	116,800			
Eliminate Book Value:				
Capital Stock—90 % of \$100,000.00..			90,000	
Surplus—90 % of \$12,000.00.....			10,800	
Goodwill.....				16,000G
Liabilities and Net Worth				
Capital Stock Preferred—Company <i>S</i> ...		50,000		
Eliminate Parent Company's 80 %....			40,000	
Minority—20 %.....				10,000M
Capital Stock Common—Company <i>S</i>		100,000		
Eliminate Parent Company's 90 %....			90,000	
Minority—10 %.....				10,000M
Surplus—Company <i>S</i>		18,000		
Applicable to Preferred—\$6,000.00:				
Eliminate Parent Company's 80 %...			4,800	
Minority—20 %.....				1,200M
Applicable to Common—\$12,000.00:				
Eliminate Parent Company's 90 %...			10,800	
Minority—10 %.....				1,200M
Surplus—Company <i>P</i>	15,600			15,600S

Arbitrary entries in Investment account.—In some instances, a parent company will not take up the profits and losses of its subsidiary but will, at intervals, make entries of an arbitrary amount to raise or lower the balance of the Investment account to an amount regarded as representing

the value of the stock owned. If the entry adjusts the balance of the account to the book value of the stock, as measured by the Capital Stock and Surplus accounts of the subsidiary, the elimination of book value at the balance sheet date will have the effect of eliminating from the consolidated balance sheet any goodwill in the stock purchase. To illustrate, Company *P* purchased 90% of the stock of Company *S*, paying \$115,000.00 therefor. At the date of acquisition, Company *P* had a capital stock of \$100,000.00 and a surplus of \$20,000.00, so that its book value was \$120,000.00. As 90% of \$120,000.00 is \$108,000.00, there was a goodwill element of \$7,000.00 in the purchase. The investment was carried at cost until the end of the year, at which time the subsidiary had a surplus of \$50,000.00, and a total net worth of \$150,000.00. As 90% of this amount is \$135,000.00, Company *P* erroneously made an entry debiting the Investment account and crediting Surplus with \$20,000.00, to raise the balance of the Investment account from \$115,000.00 to \$135,000.00. It will be noted from the following working papers that the \$7,000.00 goodwill payment was thus, in effect, written off.

	<u>Com- pany <i>P</i></u>	<u>Com- pany <i>S</i></u>	<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
Assets				
Investment in Stock of Company <i>S</i> (90%)	135,000			
Eliminate Book Value:				
Capital Stock—90% of \$100,000.00..			90,000	
Surplus—90% of \$50,000.00.....			45,000	
Liabilities				
Capital Stock—Company <i>S</i>		100,000		
Eliminate Parent Company's 90%....			90,000	
Minority Interest—10%.....				10,000M
Surplus:				
Company <i>P</i>	20,000			20,000S
Company <i>S</i>		50,000		
Eliminate Parent Company's 90%...			45,000	
Minority Interest—10%.....				5,000M

These working papers show that the goodwill of \$7,000.00 has been written off and that the parent company's surplus is only \$20,000.00, although it should be 90% of the subsidiary's \$30,000.00 profits for the year, or \$27,000.00. Because such arbitrary entries produce erroneous results, it is advisable to

reverse them by adjusting entries in the consolidated working papers, and proceed with the eliminations in the usual manner.

Book value at acquisition in excess of cost.—If the price paid by a parent company in acquiring the stock of a subsidiary is in excess of the book value of the stock at the date of acquisition, the excess is included in the consolidated balance sheet as goodwill. What treatment should be given to the opposite condition: an excess of book value at acquisition over purchase price? Let us consider a number of cases.

(1) If there is a Goodwill account on the books of the subsidiary whose stock is acquired at less than book value, the excess of the book value of the stock over its purchase price should be deducted from the goodwill of that subsidiary. Obviously, the parent company, in paying less than book value for the stock, refused to recognize the propriety of the stated book value of the goodwill.

(2) If there is no goodwill on the books of the subsidiary, but if some of its assets are overvalued and the parent company paid less than book value for the stock because of the asset overvaluation, the excess of book value over cost may be deducted in the consolidated working papers from the overvalued assets.

(3) If there is no goodwill on the books of the subsidiary whose stock was acquired at less than book value, if none of its assets are overvalued, and if there is no goodwill elsewhere in the consolidated working papers, the excess of book value over cost may be shown in the consolidated balance sheet as Capital Surplus, Surplus Arising from Consolidation, or under some other descriptive title in the surplus section.

(4) If there is no goodwill on the books of the subsidiary whose stock was acquired at less than book value, and if none of its assets are overvalued, but if goodwill items appear in the balance sheets of the other companies or arose from the purchase of the stock of other subsidiaries, it is customary to deduct the excess of book value over cost from goodwill appearing anywhere in the consolidated working papers. Although this practice is customary, it does not seem to be theoretically correct, for the following reasons:

- (a) It is difficult to see how the purchase of the stock of a subsidiary at less than book value can reduce the

goodwill of the consolidation, unless that subsidiary is making very small profits or is incurring losses which will reduce the consolidated earnings. But even in that case,

- (b) It is a well-recognized accounting principle that, while the real value of a company's goodwill is dependent upon its earnings, the amount which may be shown in its balance sheet as goodwill is determined by the price paid for goodwill. In other words, goodwill once paid for may be retained in the balance sheet regardless of subsequent earnings. This principle would appear to sanction retaining in the consolidated balance sheet all goodwill paid for by the parent company or by other subsidiaries and appearing in their balance sheets, or paid for by the parent company in acquiring the stock of other subsidiaries, regardless of the meager earnings or the losses of a subsidiary acquired at less than book value. Moreover,
- (c) While it may be regarded as conservative to offset an excess of book value over cost against any goodwill appearing in the consolidated working papers, the accountant should recognize that, in doing so, he is in effect writing off goodwill presumably paid for in other transactions. If such a conservative action is to be taken, it would seem to require the authorization of the directors of the parent company.

For these reasons the author believes that, if a subsidiary with no Goodwill account and no overvalued assets is acquired at less than book value, the excess of book value over cost should not be offset against goodwill appearing elsewhere in the consolidated working papers, but should be set up as Capital Surplus or Surplus Arising from Consolidation.

Profits in inventories.—When one company sells goods at a profit to a related company, the minority stockholders of the selling company have a right to consider that the profit has been realized, since the goods have been sold to a company in which they have no interest. The parent company, which controls the organization and looks upon the

various subsidiaries virtually as departments of the organization, should not regard the profit as realized until the goods have been resold to a purchaser outside of the organization.

Therefore, if, at the date of the consolidated balance sheet, the inventories of any of the related companies contain goods that were purchased from other related companies after the selling companies' stocks were acquired by the parent company, the inventories should be analyzed to determine how much of their present carrying value is composed of profits added by the selling companies. After this unrealized profit has been ascertained, a reserve should be created, out of the parent company's surplus, for the parent company's portion of such unrealized profit.

To illustrate, it is assumed that Company *P* owns 90% of the stock of Company *S*. Company *S* has sold goods to Company *P* during the year at a profit, and the inventory of Company *P* at the end of the year includes goods purchased from Company *S* on which the latter company made a profit of \$1,000.00. Since Company *P*, in taking up its share of the profits of Company *S*, has taken up \$900.00 of this profit, a reserve should be created by deducting \$900.00 from the parent company's surplus and transferring it to a reserve.

The reserve for unrealized profits may be shown on the consolidated balance sheet as a deduction from the inventories. Inventories should be priced at cost (unless market is lower), and cost should not include the organization's share of unrealized profits resulting from transfers from one related company to another. Or the inventories may be shown at the net amount after the intercompany profit has been deducted, without showing the reserve on the balance sheet.

Conflicting opinions concerning amount of reserve.—Some accountants set up a reserve for the entire amount of the unrealized profit instead of for the parent company's proportion thereof. But this appears incorrect because the minority stockholders are outsiders, and their share of the profit is earned as soon as the goods are sold to another corporation in which they have no interest.

Thus, if Company *P* owns 90% of the stock of Company *S*,

and if Company *P*'s inventory contains goods purchased from Company *S* on which Company *S* made a profit of \$10,000.00, it would appear that the reserve need be only 90% of \$10,000.00, or \$9,000.00, because: First, the minority's 10% of the profit is realized so far as the minority stockholders are concerned, since the goods have been sold to a company in which they have no stock interest; and second, since the parent company has taken up only 90% of the subsidiary's total profit, it has thus taken into its surplus only \$9,000.00 of profit derived from the intercompany transaction; it should therefore not be obliged to reduce its surplus \$10,000.00 by setting up a reserve for the entire intercompany profit.

But assume that Company *P* sold the goods to Company *S*, making a \$10,000.00 profit. What should be the amount of the reserve? It might appear that, since there is a 10% minority interest in Company *S*, 10% of the profit could be regarded as realized in the sense that Company *P* sold 10% of the goods to the minority interest in Company *S*. However, Company *P*'s surplus has been increased by the entire \$10,000.00 profit; unless the parent company is obliged to remove the entire \$10,000.00 from its surplus by the creation of a reserve, the parent company would be in a position arbitrarily to inflate its profits by forcing the subsidiary to purchase merchandise at such a profit as the parent company might dictate.

Care must be exercised in determining the amount of the reserve if the parent company owns several subsidiaries. To illustrate, assume that Company *P* owns 90% of the stock of Company *S* and 75% of the stock of Company *T*. If Company *S*'s inventory contains goods on which Company *T* made a \$10,000.00 profit, the reserve should be 75% of \$10,000.00, because the parent company takes up 75% of the profit of Company *T*. On the other hand, if Company *T* holds merchandise which it has purchased from Company *S*, the reserve should be 90% of the profit, because the parent company takes up 90% of the profit of Company *S*.

The situation may be further complicated by assuming that Company *P* owns merchandise that it bought from Company *S*, which made a profit of \$10,000.00 on the sale to Company *P*; furthermore, Company *S* acquired the merchandise from Company *T*, which made a profit of \$6,000.00

on the sale. Since Company *P* owns 90% of the stock of Company *S* and 75% of the stock of Company *T*, the reserve should be:

90 % of \$10,000.00 profit made by <i>S</i> on sale to <i>P</i> . . .	\$ 9,000.00
75 % of \$6,000.00 profit made by <i>T</i> on sale to <i>S</i> . . .	4,500 00
Total reserve	\$13,500.00

Profits from sales before stock acquisition.—If the inventories contain goods which were sold by one company to another before the parent company acquired control of the selling company, no reserve should be created, because the parent company did not take up a share of such profits and should not be required to reduce its surplus by an amount which has not been included therein. The companies were not related when the sale took place, and hence the profit was not intercompany profit.

Intercompany profits on construction.—When one company produces fixed assets for another related company and makes a profit on the construction, a reserve should be created to eliminate the parent company’s proportion of such profit and reduce the fixed assets to cost. As already shown in connection with inventories, the cost may properly include the profit applicable to the minority interest of the selling company. The parent company cannot equitably ask the minority stockholders of its subsidiary to forego their share of the profit on work done for a company in which they have no interest; nor can the parent company reasonably be called upon to set up a \$10,000.00 reserve for the total profit made by a subsidiary, if the parent company owns only 90% of the stock and has taken up only \$9,000.00 of the profit on the construction.

To illustrate, assume that Company *P* owns 90% of the stock of Company *S*. After the combination is effected, the latter company sells fixed assets to Company *P* at a profit of \$1,000.00. At the end of the year, Company *P* will take up \$900.00 of the profit which Company *S* made on the sale, and it should therefore create a reserve of \$900.00 for unrealized profit in fixed assets.

The question of intercompany profits on the construction of fixed assets is a much more complex one than that of inter-

company profits in inventories. Intercompany profits in inventories will become realized profits when the goods are sold to outsiders, and the reserve will disappear when the goods are disposed of. In the case of fixed assets, however, the property is not ordinarily disposed of through sale, and it might seem, therefore, that the reserve should be kept intact and appear as a deduction on the balance sheet at the original amount so long as the fixed assets are owned. But since fixed assets are virtually disposed of gradually through use and depreciation, it seems logical to reduce the depreciation charges to a basis of intercompany cost. This view is strengthened when it is remembered that depreciation should be based on cost, which cannot be two different things for two different purposes. If cost for balance sheet purposes is purchase price less intercompany profit, then cost for depreciation purposes should be the same amount. If manufacturing expense is charged with depreciation on the intercompany purchase price, the costs of manufacture are overstated, because depreciation is computed on a value in excess of the cost to the organization.

It is not difficult to put this theory into practice if the parent company owns the asset on which the intercompany profit was made. Two methods are available:

- (1) The parent company may write down the asset to intercompany cost by debiting Surplus and crediting the asset account instead of crediting a reserve for intercompany profit. Depreciation will then be computed on the carrying value of the property as shown by the asset account.
- (2) The parent company may carry the reserve and compute depreciation on the carrying value of the property as measured by the debit balance in the asset account minus the credit balance in the reserve for intercompany profit.

To illustrate, assume that Company *P* owns 90% of the stock of Company *S*, and that, during the year, Company *S* manufactured for Company *P* machinery which it delivered to Company *P* at the end of the year, billing that company \$25,000.00. The profit made by Company *S* was \$5,000.00. Company *P*, in taking up its share of the profits of Company

S, took up 90% of this amount, or \$4,500.00. If Company *P* follows the first method suggested above, it will debit its Surplus and credit the Machinery account \$4,500.00, thus reducing the asset to \$20,500.00, which is intercompany cost after the minority stockholders of Company *S* are allowed their 10% of the profit. Depreciation will then be computed on \$20,500.00. If Company *P* follows the second method suggested above, it will debit Surplus and credit a reserve for unrealized profit in fixed assets, \$4,500.00; it will then compute depreciation on the \$25,000.00 balance in the asset account minus the \$4,500.00 balance in the reserve for intercompany profit.

The theory is not so easily put into practice if the company making the profit sold the assets to another affiliated company instead of to the parent company. To illustrate, assume that Company *P* owns 90% of the stock of Company *S* and 80% of the stock of Company *T*. Company *T* has sold to Company *S* for \$50,000.00 machinery which cost \$40,000.00. When Company *P* takes up its 80% of the profits of Company *T*, it takes up \$8,000.00 of this unrealized intercompany profit and should therefore create a reserve of \$8,000.00. The first method suggested above is not practicable in this case; the asset is on the books of Company *S* while the unrealized profit reserve must be set up out of the surplus of Company *P*. It is impossible to write down the asset on the books of Company *S*, because such a write-down would involve a debit to the surplus of Company *S*, a procedure which would be improper because the intercompany profit went into *P*'s surplus. The asset will therefore go on to the books of Company *S* at \$50,000.00, and the reserve will be set up at \$8,000.00 on *P*'s books.

For consolidated balance sheet purposes, the cost of the asset was \$42,000.00, but Company *S* will compute depreciation on a basis of \$50,000.00, which was the cost to Company *S* as a separate corporation. If the rate of depreciation is 10%, the depreciation on a straight-line basis will be \$5,000.00 annually. But, from the standpoint of the organization as a unit, Company *S* has overstated its manufacturing costs by 10% of \$8,000.00, or \$800.00, and if all of the goods manufactured by Company *S* during the year have been sold outside the organization, the profits of the organiza-

tion have been understated \$800.00. In other words, since depreciation of machinery used in manufacturing is a manufacturing expense, 10% of the machinery (from an accounting standpoint) has now been converted into finished goods and sold. Ten per cent of the unrealized profit on fixed assets is thereby realized by converting the fixed assets into finished goods and selling them. At the end of the year, the parent company would therefore be justified, in the author's opinion, in transferring 10% of the \$8,000.00 reserve, or \$800.00, to its Surplus account, thus reducing the reserve on its books to \$7,200.00. The asset would then appear on the consolidated balance sheet as follows:

Machinery.	\$50,000
Less: Reserve for Intercompany Profit on Construction . . .	\$7,200
Reserve for Depreciation.	<u>5,000</u> 12,200
Depreciated Cost.	<u>\$37,800</u>

This treatment seems theoretically correct, since it produces the same result that would be produced by either the first or second method if the parent company had itself purchased the asset from Company *T*. In that case, Company *P* would carry the asset on its own books at \$42,000.00. The depreciation at 10% would be \$4,200.00, and the carrying value at the end of the first year would be:

Machinery (at Cost less Intercompany Profit)	\$42,000.00
Less Depreciation.	<u>4,200.00</u>
Depreciated Cost.	<u>\$37,800.00</u>

There is a still further complication if the finished goods have not been sold or have been sold to another company within the organization. In such an instance the intercompany profit on construction has merely been converted into an unrealized intercompany profit in inventories, for which a proper reserve should be created.

Illustration of working papers.—The treatment of intercompany profits in the consolidated balance sheet working papers will depend upon whether or not reserves have been set up on the books of the parent company. If they have been set up, they will appear in the balance sheet of the parent company and will be merely carried out to the Consolidated Balance Sheet columns. If they have not been set up on

the parent company's books, they will be created by deductions from the parent company's surplus, as illustrated below:

Consolidated Balance Sheet Working Papers

	Com- pany <i>P</i>	Com- pany <i>S</i>	Elimi- na- tions	Consoli- dated Balance Sheet
Surplus—Company <i>P</i>	40,000			
Reserve for Intercompany Profit in Inventories.				900R
Reserve for Intercompany Profit in Construction.				4,500R
Surplus.				34,600S

Stock acquired from the subsidiary.—In all illustrations heretofore presented, it has been assumed that the parent company acquired its stock by purchase from former stockholders of the subsidiary. Sometimes the stock is acquired directly from the subsidiary. The difference in the method of acquiring the stock has no effect on the method of making eliminations from the Investment account. If the Investment account has been charged with subsidiary profits and credited with subsidiary losses and dividends, the book value of the stock at the date of the balance sheet should be eliminated. If the investment is carried at cost, the parent company's Investment and Surplus accounts will be subject to the customary adjustment for the parent company's percentage of any increase or decrease in subsidiary surplus since the date of acquisition.

But it should be understood that the subsidiary surplus at the date of acquisition includes any premium paid by the parent company in acquiring the subsidiary stock. To illustrate, assume that Company *A* had an issue of \$50,000.00 of stock, all of which was outstanding in the hands of individual owners, and a surplus of \$10,000.00. An additional issue of \$70,000.00 was authorized and sold at 150, or for \$105,000.00, to Company *B*, which thus became Company *A*'s parent. If the parent company carries the investment at cost, adjustments for an increase or a decrease in subsidiary surplus should be based on a surplus of \$45,000.00 at acquisition, including the \$10,000.00 surplus before the issuance of the new stock and the \$35,000.00 premium on the new stock.

When to consolidate.—A company may be regarded as a subsidiary if a mere controlling interest in its stock is owned by another company. But a 51% interest is usually not regarded as sufficient to justify including the accounts of the subsidiary in a consolidated balance sheet.

A consolidated balance sheet is based upon the assumption that the Investment account on the parent company's books represents the net assets of the subsidiary. If the parent company owns 95% of the subsidiary stock, there is only a 5% error in the assumption, and this error is corrected by including the 5% minority interest on the liability side of the balance sheet. But if there is a 49% minority interest, the error in the assumption is virtually as great as the truth in the assumption; with so great a degree of error, it is not regarded as proper to take up the subsidiary's net assets in place of the Investment account.

Unfortunately, there is no well-accepted rule concerning the percentage of ownership required to justify the inclusion of a subsidiary's accounts in a consolidated balance sheet. Some accountants appear to believe that a 60% interest is sufficient; others regard a 75% or an 80% interest as a minimum. In the author's opinion, the size of the subsidiary should also be considered. If the subsidiary is so small that a 40% minority interest is insignificant in comparison with the net worth of the parent company, there appears to be no serious objection to consolidating its accounts. On the other hand, a 25% minority interest in a large subsidiary might be so large in proportion to the net worth of the parent that the propriety of consolidating its accounts would be doubtful.

Investments carried at cost—alternative working paper procedure.—Assume that Company *P* acquired 90% of the stock of Company *S*; at the date of acquisition, the subsidiary had \$100,000.00 of capital stock and \$50,000.00 of surplus; the acquired stock therefore had a book value of 90% of \$150,000.00, or \$135,000.00; the purchase price was \$140,000.00. The parent company carries the investment at cost. A consolidated balance sheet is to be prepared at a date subsequent to acquisition, when the subsidiary has a surplus of \$60,000.00. The parent company has

\$100,000.00 of surplus from its own operations.

The procedure explained in Chapter 45 for preparing a consolidated balance sheet when the investment is carried at cost, may be summarized as follows:

Adjust the parent company's Investment and Surplus accounts by taking up its percentage of the increase or decrease in the subsidiary's surplus since the date of acquisition.

Eliminate the parent company's percentage of the subsidiary's capital stock and surplus as of the date of the consolidated balance sheet.

These adjustments and eliminations are made as follows:

	<u>Com- pany P</u>	<u>Com- pany S</u>	<u>ADJUSTMENTS</u>		<u>Elimi- na- tions</u>	<u>Consoli- dated Balance Sheet</u>
			<u>Debit</u>	<u>Credit</u>		
Assets						
Investment in Company S—at cost.....	140,000					
Adjustment—90 % of Increase in Surplus of Company S since Acquisition.....			9,000A			
Eliminate Present Book Value:						
Capital Stock—90 % of \$100,000.00...				90,000		
Surplus—90 % of \$60,000.00.....				54,000		
Goodwill.....						5,000G
Liabilities						
Capital Stock:						
Company P.....	500,000					500,000
Company S.....		100,000				
Eliminate Company P's 90 %.....				90,000		
Minority—10 %....						10,000M
Surplus:						
Company P.....	100,000					
Adjustment—as above.....				9,000A		
Adjusted Balance..						109,000S
Company S.....		60,000				
Eliminate Company P's 90 %.....				54,000		
Minority—10 %....						6,000M

Note that the goodwill is \$5,000.00, the minority interest

is \$16,000.00, and the consolidated surplus is \$109,000.00.

As an alternative procedure, the adjustment of the parent company's Investment and Surplus accounts may be omitted, and the intercompany eliminations may be based on the subsidiary's capital stock and surplus *as of the date of acquisition*, as illustrated by the following working papers:

	Com- pany <u>P</u>	Com- pany <u>S</u>	Elimi- na- tions <u> </u>	Consoli- dated Balance Sheet <u> </u>
Assets				
Investment in Company S—at cost.....	140,000			
Eliminate Book Value at Acquisition:				
Capital Stock—90 % of \$100,000.00			90,000	
Surplus—90 % of \$50,000.00.. . . .			45,000	
Goodwill.....				5,000G
Liabilities				
Capital Stock:				
Company P.....	500,000			500,000
Company S.....		100,000		
Eliminate 90 %.. . . .			90,000	
Minority—10 %.....				10,000M
Surplus:				
Company P.....	100,000			100,000S
Company S.....		60,000		
Minority—10 % of Present Surplus.....				6,000M
Eliminate—90 % of Surplus at Acquisition.	50,000		45,000	
Add to Consolidated Sur- plus—90 % of Increase..	\$10,000			9,000S

The goodwill is \$5,000.00 and the minority interest is \$16,000.00, as before. In the first illustration, the consolidated surplus was \$109,000.00, as shown by the adjusted balance of Company P's Surplus account. In the second illustration, the consolidated surplus is again \$109,000.00, consisting of the \$100,000.00 balance in Company P's surplus, plus \$9,000.00 carried to the consolidated column from the surplus of the subsidiary.

Subsidiary's earnings available for parent's dividends.—From a legal viewpoint a parent company would probably be unable, in most states, to pay a dividend from subsidiary profits unless the profits have been realized by the parent company by the receipt of dividends from the subsidiary.

We must therefore recognize the conflict between the economic or business concept of parent company income and the legal concept of parent company income. To illustrate, assume that a parent company owns 100% of the subsidiary stock and that, during the first year of ownership:

- (1) The subsidiary earns \$20,000.00 of profits and pays a \$6,000.00 dividend. From an economic viewpoint the parent company has earned \$20,000.00 on its investment; from a legal viewpoint it can pay only \$6,000.00 of dividends from these earnings; or,
- (2) The subsidiary earns \$2,000.00 and pays a \$6,000.00 dividend (\$4,000.00 is paid from surplus created prior to acquisition). From an economic viewpoint the parent company has earned only \$2,000.00; from a legal viewpoint the parent company has increased by \$6,000.00 its surplus available for dividends; or,
- (3) The subsidiary loses \$10,000.00 and pays a \$6,000.00 dividend (from surplus created prior to acquisition). From an economic viewpoint the parent company has lost \$10,000.00, but from a legal viewpoint its surplus available for dividends has increased \$6,000.00.

Because of this conflict between the economic and the legal concepts of parent company earnings from subsidiary investments, the two following methods of parent company accounting are in use:

1. *Method based on the legal viewpoint regarding earnings.*—Those who adhere to this viewpoint make entries as follows:

For subsidiary profits: No entry

For subsidiary losses: No entry

For subsidiary dividends: Debit Cash and credit an income account.

This method is subject to two criticisms: First, the investment is carried at cost although the underlying value of the investment is increased by subsidiary profits and is decreased by subsidiary losses and dividends; second, it permits such absurdities as taking up a subsidiary dividend as income

although the operations of the subsidiary have resulted in a loss [see (3) above].

2. *Method based on the economic viewpoint regarding earnings.*—Those who adhere to this viewpoint make entries as follows:

For subsidiary profits: Debit the Investment account and credit an income account.

For subsidiary losses: Credit the Investment account and debit a loss account.

For subsidiary dividends: Credit the Investment account and debit Cash.

This method has the advantage of increasing and decreasing the Investment account balance proportionately to increases and decreases in the underlying net assets of the subsidiary, and it more truly reflects the parent company's income or loss from the ownership of the subsidiary. However, it is subject to the criticism that, if the subsidiary's earnings exceed its dividends, the parent company's Surplus will be credited with amounts which it cannot legally use for dividends.

It would seem that some method should be devised which would harmonize the economic and legal viewpoints, and the author suggests the following procedure:

For subsidiary profits:

Debit Investment account.

Credit Subsidiary Undivided Profits.

For subsidiary losses:

Debit Subsidiary Undivided Profits.

Credit Investment account.

For subsidiary dividends:

Debit Cash.

Credit Investment account.

Debit Subsidiary Undivided Profits.

Credit Surplus.

Assuming that, since the date of acquisition, the subsidiary has made profits of \$30,000.00, suffered losses of \$5,000.00, and paid dividends of \$10,000.00, the accounts would contain the entries shown on the opposite page.

	Investment Account	Subsidiary Undivided Profits	Surplus
Cost of Stock (say).....	\$100,000		
Surplus from Parent Company's own Operations (say).....			\$60,000
Subsidiary Profits.....	30,000	\$30,000	
Subsidiary Losses.....	\$ 5,000	\$ 5,000	
Subsidiary Dividend: Amount Received.....	10,000		
Transfer to Surplus Available for Parent Company Dividends.....		10,000	10,000
Balances.....	<u>\$115,000</u>	<u>\$15,000</u>	<u>\$70,000</u>

The net worth section of the balance sheet would appear as follows:

Net Worth:	
Capital Stock.....	\$500,000.00
Surplus Available for Dividends.....	70,000.00
Subsidiary Profits since Acquisition in Excess of Dividends Received.....	<u>15,000.00</u>
Total.....	\$585,000.00

This balance sheet presentation indicates that the parent company's surplus from an economic viewpoint is \$15,000.00 greater than its surplus from a legal viewpoint.

But suppose that the subsidiary's dividends since acquisition have exceeded its profits since acquisition, as might happen if the subsidiary had a surplus at the date of acquisition. The parent company's accounts might then appear as follows:

	<u>Debit</u>	<u>Credit</u>
Subsidiary Undivided Profits:		
Profits.....		\$ 5,000.00
Dividends.....	\$20,000.00	
Surplus:		
From Parent's Own Operations....		60,000.00
Dividends from Subsidiary.....		20,000.00

We now face the peculiar fact that the parent company is apparently legally able to pay a \$20,000.00 dividend from surplus created by subsidiary dividends, although the subsidiary has earned only \$5,000.00 since the parent company acquired its stock. In other words, it appears that the parent company's surplus from a legal viewpoint is \$15,000.00 greater than its surplus from an economic viewpoint. This condition is reflected in the following net worth section of the balance sheet:

Net Worth:	
Capital Stock.....	\$500,000.00
Surplus Available for Dividends.....	80,000.00
Subsidiary Dividends Received in Excess of Profits Earned since Acquisition.....	<u>15,000.00*</u>
Total.....	\$565,000.00

The net worth sections illustrated would be used only in an unconsolidated balance sheet of the parent company, in which it is important to recognize the separate corporate

entity of the parent company, which is the basis for the determination of surplus legally available for dividends. In consolidated balance sheets, the net worth sections would appear as follows:

First case:

Net Worth:		
Capital Stock.....	\$500,000.00	
Surplus.....	<u>85,000.00</u>	
Total.....		\$585,000.00

Second case:

Net Worth:		
Capital Stock.....	\$500,000.00	
Surplus.	<u>65,000.00</u>	
Total.....		\$565,000.00

CHAPTER 48

PURCHASES AND SALES OF SUBSIDIARY STOCK— MAJOR AND MINOR PARENT COMPANIES

First illustration: Several purchases.—In this illustration it is assumed that the parent company (Company *P*) acquires its interest in the subsidiary (Company *S*) by several purchases of stock as follows:

December 31, 1930—600 shares, or a 60% interest.

December 31, 1931—100 shares, or a 10% interest.

December 31, 1932—200 shares, or a 20% interest.

and that all dividends were paid on December 30.

The illustration comprises the following statements and working papers:

(A) *On the assumption that the parent company takes up its share of the subsidiary's profits and dividends:*

Page 290.—A statement of the Surplus account of the subsidiary, and the Surplus and Investment accounts of the parent company.

Page 291.—Working papers for the preparation of the consolidated balance sheet.

(B) *On the assumption that the parent company carries the investment at cost:*

Page 292.—A statement of the Surplus account of the subsidiary, and the Surplus and Investment accounts of the parent company.

Page 293.—A work sheet for the determination of the adjustment to be made in the parent company's Surplus and Investment accounts to take up its percentages of the increase in subsidiary surplus.

Page 294.—Working papers for the preparation of the consolidated balance sheet.

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COMPANY P AND SUBSIDIARY S
Statement of Surplus and Investment Accounts
(Subsidiary Profits and Dividends Taken Up)

	COMPANY P		
	Investment in		
	Company S	Company S	Surplus
	Per Cent	Amount	
December 31, 1930—Purchase, 600 Shares.....	60 %	\$ 99,000.00	\$100,000.00
1931: Profits: Company S.....		6,000.00	6,000.00
Company P.....			20,000.00
Dividends: Company S.....		3,600.00*	
Company P.....			12,000.00*
Purchase—December 31, 100 Shares.....	10	16,000.00	
Balances.....	70 %	\$117,400.00	\$114,000.00
1932: Profits: Company S.....		7,000.00	7,000.00
Company P.....			20,000.00
Dividends: Company S.....		4,200.00*	
Company P.....			12,000.00*
Purchase—December 31, 200 Shares.....	20	33,000.00	
Balances.....	90 %	\$153,200.00	\$129,000.00
1933: Profits: Company S.....		9,000.00	9,000.00
Company P.....			20,000.00
Dividends: Company S.....		5,400.00*	
Company P.....			12,000.00*
Balances.....	90 %	\$156,800.00	\$146,000.00
1934: Profits: Company S.....		9,000.00	9,000.00
Company P.....			20,000.00
Dividends: Company S.....		5,400.00*	
Company P.....			12,000.00*
Balances.....	90 %	\$160,400.00	\$163,000.00

* Deductions.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934
(Subsidiary Profits and Dividends Taken Up)

	Company <i>P</i>	Company <i>S</i>	Elimina- tions	Consolidated Balance Sheet
Assets				
Cash.....	40,000.00	30,000.00		70,000.00
Accounts Receivable.....	70,000.00	65,000.00		135,000.00
Inventory.....	102,600.00	86,000.00		188,600.00
Investment in Company S—90%.....	160,400.00			
Eliminate:				
Capital Stock.....			90,000.00	
Surplus.....			59,400.00	
Goodwill.....				11,000.00G
	373,000.00	181,000.00	149,400.00	404,600.00
Liabilities				
Accounts Payable.....	10,000.00	15,000.00		25,000.00
Capital Stock:				
Company P.....	200,000.00			200,000.00
Company S.....		100,000.00	90,000.00	10,000.00M
Surplus:				
Company P.....	163,000.00			163,000.00
Company S.....		66,000.00	59,400.00	6,600.00M
	373,000.00	181,000.00	149,400.00	404,600.00

COMPANY P AND SUBSIDIARY S
Statement of Surplus and Investment Accounts
(Investment Carried at Cost)

	COMPANY P		
	Investment in Company S		Surplus
	Per Cent	Cost	
December 31, 1930—Purchase, 600 Shares.....	60 %	\$ 99,000.00	\$100,000.00
1931: Profits.....			20,000.00
Dividends: Company S.....			3,600.00
Company P.....			12,000.00*
Purchase—December 31, 100 Shares.....	10	16,000.00	
Balances.....	70 %	\$115,000.00	\$111,600.00
1932: Profits.....			20,000.00
Dividends: Company S.....			4,200.00
Company P.....			12,000.00*
Purchase—December 31, 200 Shares.....	20	33,000.00	
Balances.....	90 %	\$148,000.00	\$123,800.00
1933: Profits.....			20,000.00
Dividends: Company S.....			5,400.00
Company P.....			12,000.00*
Balances.....	90 %	\$148,000.00	\$137,200.00
1934: Profits.....			20,000.00
Dividends: Company S.....			5,400.00
Company P.....			12,000.00*
Balances.....	90 %	\$148,000.00	\$150,600.00

* Deduction.

Work Sheet to Determine Adjustment of Parent Company's Surplus and Investment Accounts
(Investment Carried at Cost)

Acquisition Dates	Company S		Company P	
	Surplus	Investment in Company S	Per Cent	Amount
December 31, 1930—P buys 60% of S	\$50,000.00		60%	\$ 2,400.00
1931—Increase	4,000.00			
December 31, 1931—P buys 10% of S	\$54,000.00		70%	2,800.00
1932—Increase	4,000.00			
December 31, 1932—P buys 20% of S	\$58,000.00		90%	7,200.00
1933-1934—Increase	8,000.00			
Balance—December 31, 1934	\$66,000.00			
Adjustment				<u>\$12,400.00</u>

Note that this work sheet shows the surplus of the subsidiary on each stock acquisition date, the increases in the subsidiary surplus in the intervals, and the parent company's percentages of such increases.

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934
(Investment Carried at Cost)

	Company P	Company S	ADJUSTMENTS		Elimina- tions	Consolidated Balance Sheet
			Debit	Credit		
Assets						
Cash.....	40,000.00	30,000.00				70,000.00
Accounts Receivable.....	70,000.00	65,000.00				135,000.00
Inventory.....	102,600.00	86,000.00				188,600.00
Investment in Company S—90%—Cost				12,400.00		
Adjustment.....						
Eliminate:						
Capital Stock.....					90,000.00	
Surplus.....					59,400.00	
Goodwill.....					<u>149,400.00</u>	<u>11,000.00G</u>
	<u>360,600.00</u>	<u>181,000.00</u>				<u>404,600.00</u>
Liabilities						
Accounts Payable.....	10,000.00	15,000.00				25,000.00
Capital Stock:						
Company A.....	200,000.00					200,000.00
Company B.....		100,000.00			90,000.00	10,000.00M
Surplus:						
Company A.....		66,000.00		12,400.00		163,000.00
Company B.....		<u>181,000.00</u>	<u>12,400.00</u>	<u>12,400.00</u>	59,400.00	6,600.00M
	<u>360,600.00</u>	<u>181,000.00</u>	<u>12,400.00</u>	<u>12,400.00</u>	<u>149,400.00</u>	<u>404,600.00</u>

Note that these working papers include the adjustment determined in the work sheet on page 293.

Second illustration: Purchases and sales.—In this illustration, Company *P* made several purchases of the stock of Company *S*, and also made two sales of the stock; the facts with respect to these purchases and sales are shown in the statements. The illustration comprises the following statements, working papers, and comments:

- (A) *On the assumption that the parent company takes up its share of the subsidiary's profits and dividends:*

Page 296.—Statement of the Surplus account of the subsidiary, and the Surplus and Investment accounts of the parent company.

Page 295.—Comments and explanations applicable to the sales and purchases shown in the statement on page 296.

Page 298.—Working papers for the preparation of the consolidated balance sheet.

Page 298.—Proof of the goodwill determined in the working papers on the same page.

- (B) *On the assumption that the parent company carries the investment at cost:*

Page 300.—Statement of the Surplus account of the subsidiary, and the Surplus and Investment accounts of the parent company.

Page 301.—Work sheet to determine the adjustment of the parent company's Surplus and Investment accounts.

Page 302.—Comment on the effect of stock sales on the adjustment.

Page 303.—Working papers for the preparation of the consolidated balance sheet.

Comments on entries for sales. (*See statement, page 296.*)—

All sales are regarded as having been made from the first stock purchased, and the Investment account is relieved of the carrying value of the stock sold—that is, the cost plus the net increase resulting from taking up profits and dividends. As the first purchase consisted of 600 shares, and as each sale disposed of 50 shares, each sale represented $\frac{5}{60}$ of the

COMPANY P AND SUBSIDIARY S
Statement of Surplus and Investment Accounts
(Subsidiary Profits and Dividends Taken Up)

	COMPANY P		
	Company S	Investment In Company S	Surplus
	Surplus	Per Cent	Amount
December 31, 1930—Purchase, 600 Shares.....	\$50,000.00	60%	\$ 99,000.00
1931: Profits: Company S.....	10,000.00		6,000.00
Dividends: Company S.....	6,000.00*		3,600.00*
Purchase—December 31—100 Shares.....		10	16,000.00
Balances.....	\$54,000.00	70%	\$117,400.00
1932: Profits: Company S.....	10,000.00		7,000.00
Dividends: Company S.....	6,000.00*		4,200.00*
Purchase—December 31—200 Shares.....		20	33,000.00
Balances.....	\$58,000.00	90%	\$153,200.00
1933: Sale—January 1—50 Shares (see comments).....	10,000.00	5	8,650.00*
Profits: Company S.....	6,000.00*		8,500.00
Dividends: Company S.....			5,100.00*
Balances.....	\$62,000.00	85%	\$147,950.00
1934: Sale—June 30—50 Shares (see comments).....	10,000.00	5	8,850.00*
Purchase—September 30—100 Shares (see comments).....		10	19,000.00
Profits: Company S.....			8,000.00
80% for Year.....			250.00
10% for 1/4 Year.....			5,400.00*
Company P.....	6,000.00*		12,000.00*
Dividends: Company S.....			\$146,850.00
Balances.....	\$66,000.00	90%	\$160,950.00
* Deductions.			1,150.00
			8,000.00
			250.00
			20,000.00
			12,000.00*
			\$164,250.00

PURCHASES AND SALES OF SUBSIDIARY STOCK 297

first stock purchased. The amounts credited to the Investment account and the profits on the sales are determined as follows:

First sale—January 1, 1933:

Sale price.....	\$10,000
Less carrying value:	
Cost— $\frac{5}{60}$ of \$99,000.00.....	\$8,250
Increase since purchase:	
1931—Profits less dividends on 600 shares owned \$2,400	
$\frac{5}{60}$ thereof.....	200
1932—Profits less dividends on 700 shares owned..2,800	
$\frac{5}{70}$ thereof.....	200
Total carrying value (credited to Investment).....	8,650
Profit (credited to Surplus).....	<u>\$ 1,350</u>

Second sale—June 30, 1934:

Sale price.....	\$10,000
Less carrying value:	
Cost— $\frac{5}{60}$ of \$99,000.00.....	\$8,250
Increase—1931 (computed as above).....	200
Increase—1932 (computed as above).....	200
Increase—1933—Profits less dividends on 850	
shares owned.....	\$3,400
$\frac{5}{85}$ thereof.....	200
Total carrying value (credited to Investment).....	8,850
Profit (credited to Surplus).....	<u>\$ 1,150</u>

In connection with the second sale, it will be noted that the subsidiary's profit to June 30, 1934, the date of the sale, has not been taken up by the parent company. If it were known that the profit of Company *S* for the first six months of 1934 was (for example) \$5,000.00 (half of the profit for the year), the entries to be made by Company *P* at the time of the sale could be:

	Investment in Company <i>S</i>	Surplus
To take up 5% of profit of Company <i>S</i> for the first 6 months of 1934.....	\$ 250.00	\$250.00
Sale of 50 shares.....	9,100.00*	900.00

* Deduction.

The net effect of the two methods is the same: In the second method, the Investment account is debited with \$250.00 and credited with \$9,100.00, making a net credit of

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\$8,850.00, as in the first method. In the second method, the \$1,150.00 credit to Surplus consists of two parts: the \$250.00 share of income applicable to the stock to June 30, 1934, and \$900.00 profit on the sale.

Comment on stock purchase during year.—One hundred shares of stock (10% interest) were purchased on September 30, 1934. The Investment account was charged with the cost. It will be noted that the subsidiary profits for 1934 are taken up as follows:

Applicable to 800 shares owned during the entire year:	
80% of \$10,000.00.....	\$8,000.00
Applicable to 100 shares owned during the last quarter of the year:	
¼ of 10% of \$10,000.00.....	250.00

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet Working Papers
December 31, 1934
(Subsidiary Profits and Dividends Taken Up)

	Com- pany P	Com- pany S	Elimi- nations	Consoli- dated Balance Sheet
Assets				
Cash.....	40,700	30,000		70,700
Accounts Receivable.....	70,000	65,000		135,000
Inventory.....	102,600	86,000		188,600
Investment in Company S—90% ..	160,950			
Eliminate:				
Capital Stock—90%.....			90,000	
Surplus.....			59,400	
Goodwill.....				11,550
	<u>374,250</u>	<u>181,000</u>	<u>149,400</u>	<u>405,850</u>
Liabilities				
Accounts Payable.....	10,000	15,000		25,000
Capital Stock:				
Company P.....	200,000			200,000
Company S.....		100,000	90,000	10,000M
Surplus:				
Company P.....	164,250			164,250
Company S.....		66,000	59,400	6,600M
	<u>374,250</u>	<u>181,000</u>	<u>149,400</u>	<u>405,850</u>

Proof of goodwill shown in consolidated working papers.—The goodwill shown in the consolidated working papers consists of the goodwill payments made in connection with the various stock purchases, minus the goodwill payments

PURCHASES AND SALES OF SUBSIDIARY STOCK 299

applicable to the stock sold. On the first-in first-out theory, the stock sold is taken from the first stock purchased; the goodwill payment on the first purchase was \$15.00 per share, as shown below; therefore the goodwill payment applicable to the stock sold is regarded as \$15.00 per share.

As illustrated in the statement of the parent company's accounts on page 296, the parent company took up (as applicable to the stock purchased on September 30, 1934) only the portion of the profit applicable to the three months subsequent to purchase. Therefore the profits for the first nine months are included in the book value of the stock on September 30, in determining the goodwill applicable to the stock purchase on that date.

Purchase—December 31, 1930:		
Cost of 600 Shares—60 %	\$99,000	
Book value:		
Stock and Surplus of Company S (page 296)	\$150,000	
60 % thereof	<u>90,000</u>	
Goodwill (\$15.00 per share)		\$ 9,000
Purchase—December 31, 1931:		
Cost of 100 Shares—10 %	\$16,000	
Book value:		
Stock and Surplus of Company S (page 296)	\$154,000	
10 % thereof	<u>15,400</u>	
Goodwill (\$6.00 per share)		600
Purchase—December 31, 1932:		
Cost of 200 Shares—20 %	\$33,000	
Book value:		
Stock and Surplus of Company S (page 296)	\$158,000	
20 % thereof	<u>31,600</u>	
Goodwill (\$7.00 per share)		1,400
Sale—January 1, 1933—50 Shares—Regarded (on first-in first-out theory) as purchased December 31, 1930; hence the goodwill was \$15.00 per share. \$15.00 × 50		750*
Sale—June 30, 1934—\$15.00 × 50		750*
Purchase—September 30, 1934:		
Cost of 100 Shares	\$19,000	
Book value:		
Stock and Surplus of Company S—December 31, 1933 (page 296)	\$162,000	
Add profits to Sept. 30, 1934— $\frac{3}{4}$ of \$10,000	<u>7,500</u>	
Total	<u>\$169,500</u>	
10 % thereof	<u>16,950</u>	
Goodwill—\$20.50 per share		2,050
Total Goodwill		<u>\$11,550</u>

* Deductions.

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COMPANY P AND SUBSIDIARY S Statement of Surplus and Investment Accounts (Investment Carried at Cost)

	COMPANY P		Surplus
	Company S Surplus	Investment In Company S Per Cent	
December 31, 1930—Purchase, 600 Shares.....	\$50,000.00	60%	\$100,000.00
1931: Profits.....	10,000.00		20,000.00
Dividends: Company S.....	6,000.00*		3,600.00
Company P.....			12,000.00*
Purchase—December 31—100 Shares.....		10%	16,000.00
Balances.....	\$54,000.00	70%	\$115,000.00
1932: Profits.....	10,000.00		20,000.00
Dividends: Company S.....	6,000.00*		4,200.00
Company P.....			12,000.00*
Purchase—December 31—200 Shares.....		20%	33,000.00
Balances.....	\$58,000.00	90%	\$148,000.00
1933: Sale—January 1—50 Shares (see note).....	10,000.00	5%	8,250.00*
Profits.....	6,000.00*		20,000.00
Dividends: Company S.....	6,000.00*		5,100.00
Company P.....			12,000.00*
Balances.....	\$62,000.00	85%	\$139,750.00
1934: Sale—June 30—50 Shares (see note).....	10,000.00	5%	8,250.00*
Purchase—September 30—100 Shares.....	6,000.00*	10%	19,000.00
Profits.....	6,000.00*		20,000.00
Dividends: Company S.....	6,000.00*		5,400.00
Company P.....			12,000.00*
Balances.....	\$66,000.00	90%	\$150,500.00
			\$153,800.00

* Deduction.

Note.—Since the investment is carried at cost, only the cost of the stock sold is credited to the Investment account. The stock sold is regarded as a part of the first stock purchased. The profits on the sales are computed as follows:

Sale price.....	\$10,000.00
Cost— $\frac{1}{2}$ of \$99,000.00.....	8,250.00
Profit.....	<u>\$ 1,750.00</u>

Work Sheet to Determine Adjustment of Parent Company's Surplus and Investment Accounts
(Investment Carried at Cost)

Acquisition Dates	Company S		Company P	
	Surplus	Per Cent	Investment In Company S	Amount
December 31, 1930—P buys 600 Shares, of which 500 are retained.....	\$50,000.00	50 %	\$ 2,000.00	
Increase—1931.....	4,000.00			
December 31, 1931—P buys 100 Shares.....	\$54,000.00	60	2,400.00	
Increase—1932.....	4,000.00			
December 31, 1932—P buys 200 Shares.....	\$58,000.00	80	3,200.00	
Increase—1933.....	4,000.00			
Increase to September 30, 1934— $\frac{3}{4}$ of year's profit.....	7,500.00	80	6,000.00	
September 30, 1934—P buys 100 Shares.....	\$69,500.00	90	3,150.00*	
Decrease to December 31, 1934— $\frac{1}{4}$ of year's profit minus dividend.....	3,500.00*			
Balance—December 31, 1934.....	\$66,000.00			
Adjustment.....				<u>\$10,450.00</u>

* Deduction.

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Effect of sales on computation of adjustment.—It will be noted that, in the work sheet on page 301, the adjustment for each year is based, not on the percentage of stock owned during the year, but on the percentage of stock owned and *retained to the end of the period*. For instance, the parent company owned 60% of the subsidiary stock during 1931, but it subsequently sold 10%; therefore the 1931 adjustment is for only 50% of the increase in the subsidiary's surplus during that year. The operating income applicable to the 10% sold should be ignored, because, since the investment was carried at cost, the amounts taken into the parent company's Surplus as profits on sales of stock really include the parent company's share of the subsidiary's earnings (minus dividends received) applicable to the stock sold. This can be proved by comparing the entries for profit on stock sales under the two methods of accounting.

	Investment Car- ried at Cost (See page 300)	Subsidiary Profits Taken Up (See page 296)
Profit on first sale.	\$1,750.00	\$1,350.00
Profit on second sale.	1,750.00	1,150.00
Total.	<u>\$3,500.00</u>	<u>\$2,500.00</u>

The excess \$1,000.00 recorded as profit on sales (if the investment is carried at cost) is really the excess of subsidiary profits over dividends (on the 100 shares sold) during the period that the shares were owned by the parent company, as shown below (the annual profits were \$10.00 per share and the dividends were \$6.00 per share, leaving a net increase in surplus of \$4.00 per share):

1931—100 shares.	\$ 400.00
1932—100 shares.	400.00
1933— 50 shares.	200.00
Total.	<u>\$1,000.00</u>

Consolidated balance sheet working papers.—In the following working papers the adjustment of the parent company's Surplus and Investment accounts as determined on page 301 is applied, and eliminations are then made as in the working papers on page 298.

PURCHASES AND SALES OF SUBSIDIARY STOCK 303

COMPANY P AND SUBSIDIARY S
 Consolidated Balance Sheet Working Papers
 December 31, 1934
 (Investment Carried at Cost)

	Company P	Company S	ADJUSTMENTS		Elimina- tions	Consolidated Balance Sheet
			Debit	Credit		
Assets						
Cash.....	40,700.00	30,000.00				70,700.00
Accounts Receivable	70,000.00	65,000.00				135,000.00
Inventory	102,600.00	86,000.00				188,600.00
Investment in Company S—90%—Cost	150,500.00					
Adjustment.....			10,450.00			
Eliminate:						
Capital Stock—90%.....				90,000.00		
Surplus—90%.....				59,400.00		
Goodwill.....						
	<u>363,800.00</u>	<u>181,000.00</u>		<u>149,400.00</u>		<u>11,550.00</u>
						<u>405,850.00</u>
Liabilities						
Accounts Payable.....	10,000.00	15,000.00				
Capital Stock:						
Company P.....	200,000.00					200,000.00
Company S.....		100,000.00				10,000.00M
Surplus:						
Company P.....	153,800.00				10,450.00	164,250.00
Company S.....		66,000.00			59,400.00	6,600.00M
	<u>363,800.00</u>	<u>181,000.00</u>		<u>10,450.00</u>	<u>149,400.00</u>	<u>405,850.00</u>

Third illustration: Control through a minor parent company.—In this illustration, Company *A* acquires an 80% interest in Company *B*. Since Company *B* owns a 90% interest in Company *C*, Company *A* enjoys a control of Company *C* through the minor parent company, *B*. The illustration comprises the following statements and working papers:

- (A) *On the assumption that the parent companies record their shares of subsidiary profits, losses, and dividends through the Investment accounts:*

Page 306.—A statement of the Surplus accounts of all companies, and of the Investment accounts on the books of the minor parent company, *B*, and the major parent company, *A*.

In this statement, note that, after Company *B* has taken up its 90% of the profit of Company *C*, Company *A* takes up 80% of the amount taken up by Company *B*. For instance, in 1932, Company *C* made a profit of \$6,000.00; Company *B* took up 90% thereof, or \$5,400.00; Company *A* then took up 80% of \$5,400.00, or \$4,320.00. In this manner the major parent company, *A*, took up its share of the total profit of *B*, including the profit from *B*'s own operations, and the profit which *B* was entitled to take up because of its status as a parent company owning a controlling interest in the stock of *C*.

Page 307.—Consolidated balance sheet working papers.

Note that the eliminations from the Investment account on the books of the minor parent company, *B*, are based on the surplus of the subsidiary, *C*, at the balance sheet date; in other words, no new difficulty with respect to

eliminations is here introduced.

Note also the Minority column used to assemble the details with respect to the minority interests.

(B) *On the assumption that the investments are carried at cost:*

Page 308.—A statement of the Surplus accounts of all companies, and of the Investment accounts on the books of the minor and major parent companies.

In this statement, note that each parent company takes up the dividends received from its own subsidiary, but that Company A does not make any entries with respect to the dividends received by Company B from Company C.

Page 309.—Work sheet to determine adjustments to be made in the Surplus and Investment accounts of the major and minor parent companies, A and B.

Note that Company B's Surplus and Investment accounts are adjusted for its 90% of the increase (during 1930 and 1931) and of the decrease (during 1932 and 1933) in the surplus of Company C. The Surplus and Investment accounts on the books of Company A are adjusted for its 80% of the decrease in Company B's surplus per books, and also for 80% of Company B's adjustments.

Page 310.—Consolidated balance sheet working papers.

Note that these working papers contain the adjustments determined in the work sheet on page 309, and that, after these adjustments are applied, the same eliminations can be made as those in the consolidated working papers on page 307.

COMPANY A AND SUBSIDIARIES B AND C
Statement of Surplus and Investment Accounts
(Subsidiary Profits, Losses, and Dividends Taken Up)

	COMPANY B			COMPANY A			
	Company C	Investment In Company C		Per Cent	Investment In Company B		Surplus
		Surplus	Amount		Amount	Surplus	
1929: Purchase—December 31.....							
1930: Profits: Company C.....	\$50,000	\$140,000	90%				
Company B.....	20,000	18,000					
Dividends: Company C.....	8,000*	7,200*					
Company B.....							
Balances.....	<u>\$62,000</u>	<u>\$150,800</u>	<u>90%</u>				
1931: Profits: Company C.....	18,000	16,200					
Company B.....							
Dividends: Company C.....	8,000*	7,200*					
Company B.....							
Purchase—December 31.....							10,000*
Balances.....	<u>\$72,000</u>	<u>\$159,800</u>	<u>90%</u>				
1932: Profits: Company C (see comment, page 304)	6,000	5,400					
Company B.....							
Company A.....							
Dividends: Company C.....	8,000*	7,200*					
Company B.....							
Company A.....							
Balances.....	<u>\$70,000</u>	<u>\$158,000</u>	<u>90%</u>				
1933: Profits (Losses*): Company C.....	5,000*	4,500*					
Company B.....							
Company A.....							
Dividends: Company C.....	8,000*	7,200*					
Company B.....							
Company A.....							
Balances.....	<u>\$57,000</u>	<u>\$146,300</u>	<u>90%</u>				
* Deduction.							

COMPANY A AND SUBSIDIARIES B AND C

Consolidated Balance Sheet Working Papers

December 31, 1933

(Subsidiary Profits, Losses, and Dividends Taken Up)

	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>	<u>Elimina- tions</u>	<u>Mi- nority</u>	<u>Consoli- dated</u>
Assets						
Cash.....	47,640 00	40,800 00	37,000 00			95,440 00
Accounts Receivable.....	50,000 00	80,000 00	80,000 00			210,000 00
Inventories.....	60,000 00	70,000 00	50,000 00			180,000 00
Investment in Company B—80%.....	266,680.00					
Eliminate:						
Capital Stock.....				160,000.00		
Surplus.....				101,680 00		
Goodwill.....						
Investment in Company C—90%.....		146,300.00				5,000.00G
Eliminate:						
Capital Stock.....				90,000 00		
Surplus.....				51,300 00		
Goodwill.....						
	<u>394,320 00</u>	<u>337,100 00</u>	<u>167,000 00</u>	<u>402,980 00</u>		<u>5,000.00G</u>
Liabilities						
Accounts Payable.....	10,000 00	10,000 00	10,000 00			30,000 00
Capital Stock:						
Company A.....	250,000 00					250,000 00
Company B.....		200,000 00				
Company C.....			100,000 00			
Surplus:						
Company A.....	134,320 00					134,320 00
Company B.....		127,100 00				25,420 00
Company C.....			57,000 00			5,700 00
Total Minority Interest.....					81,120 00	81,120 00
	<u>394,320 00</u>	<u>337,100 00</u>	<u>167,000 00</u>	<u>402,980 00</u>		<u>495,440 00</u>

COMPANY A AND SUBSIDIARIES B AND C
Statement of Surplus and Investment Accounts
(Investments Carried at Cost)

	COMPANY B			COMPANY A		
	Investment In Company C		Surplus	Investment In Company B		Surplus
	Per Cent	Amount		Per Cent	Amount	
1929: Purchase—December 31	90%	\$140,000.00	\$100,000.00			
1930: Profits			20,000.00			
Dividends: Company C			7,200.00			
Company B			10,000.00*			
Balances	90%	\$140,000.00	\$117,200.00			
1931: Profits			15,000.00			
Dividends: Company C			7,200.00			
Company B			10,000.00*			
Purchase—December 31	90%	\$140,000.00	\$129,400.00	80%	\$284,360.00	\$150,000.00
Balances			3,000.00	80%	\$284,360.00	\$150,000.00
1932: Profits			7,200.00			30,000.00
Dividends: Company C			10,000.00*			8,000.00
Company B						25,000.00*
Company A						
Balances	90%	\$140,000.00	\$129,600.00	80%	\$284,360.00	\$163,000.00
1933: Profits (Losses*)			6,000.00*			6,000.00
Dividends: Company C			7,200.00			
Company B			10,000.00*			8,000.00
Company A						25,000.00*
Balances	90%	\$140,000.00	\$120,800.00	80%	\$284,360.00	\$152,000.00

* Deduction.

**Work Sheet to Determine Adjustments of
Parent Companies' Surplus and Investment Accounts**
(Investments Carried at Cost)

<u>Acquisition Dates</u>	SUBSIDIARIES' SURPLUS ACCOUNTS—PER BOOKS		COMPANY B		COMPANY A	
	Company C	Company B	Investment In Company C	Amount	Investment In Company B	Amount
December 31, 1929—B buys 90% of C.....	\$50,000.00		90%	\$19,800.00		
1930-1931 Increase.....	22,000.00					
December 31, 1931—A buys 80% of B.....	\$72,000.00	\$129,400.00				
1932-1933 Decrease:						
Company C.....	15,000.00*		90	13,500.00*	80%	\$10,800.00*
Company B.....		8,600.00*			80	6,880.00*
Balances—December 31, 1933.....	\$57,000.00	\$120,800.00				
Total Adjustments: Company B.....		6,300.00		\$ 6,300.00		
Company A.....						
Adjusted Balances.....	<u>\$57,000.00</u>	<u>\$127,100.00</u>				<u>\$17,680.00*</u>
Eliminations:						
Company B—90%.....	\$51,300.00					
Company A—80%.....		\$101,680.00				
Minority Interests.....	5,700.00	25,420.00				
Totals.....	<u>\$57,000.00</u>	<u>\$127,100.00</u>				

* Deduction.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Balance Sheet Working Papers
December 31, 1933

(Investments Carried at Cost)

	Com- pany A	Com- pany B	Com- pany C	ADJUSTMENTS		Elimi- nations	Mi- nority	Conso- li- dated
				Debit	Credit			
Assets								
Cash.....	17,640	40,800	37,000					95,440
Accounts Receivable.....	50,000	80,000	80,000					210,000
Inventories.....	60,000	70,000	50,000					180,000
Investment in Company B—80%—Cost.....	284,360							
Adjustment.....					17,680(A)			
Eliminate:								
Capital Stock.....					160,000			
Surplus.....					101,680			
Goodwill.....								5,000G
Investment in Company C—90%—Cost.....		140,000						
Adjustment.....								
Eliminate:								
Capital Stock.....					90,000			
Surplus.....					51,300			
Goodwill.....								5,000G
	<u>412,000</u>	<u>330,800</u>	<u>167,000</u>		<u>402,980</u>			<u>495,440</u>
Accounts Payable.....	10,000	10,000	10,000					30,000
Capital Stock:								
Company A.....	250,000							
Company B.....		200,000					40,000	
Company C.....			100,000				10,000	
Surplus:								
Company A.....	152,000							
Company B.....		120,800					25,420	
Company C.....			57,000				5,700	
Total Minority Interest.....								81,120
	<u>412,000</u>	<u>330,800</u>	<u>167,000</u>	<u>23,980</u>	<u>23,980</u>			<u>495,440</u>

Fourth illustration: Control through minor parent company and direct.—In this illustration Company *A* buys 60%, and later an additional 20%, of the stock of Company *B*. Company *B* buys 70%, and later an additional 5%, of the stock of Company *C*. Company *A* buys 20%, and later an additional 5%, of the stock of Company *C*. The stockholdings are summarized as follows:

During 1929 and 1930,	<i>A</i> owns 60% of <i>B</i> .
During 1931,	<i>A</i> owns 60% of <i>B</i> ; <i>B</i> owns 70% of <i>C</i> .
During 1932,	<i>A</i> owns 60% of <i>B</i> and 20% of <i>C</i> ; <i>B</i> owns 70% of <i>C</i> .
During 1933,	<i>A</i> owns 80% of <i>B</i> and 20% of <i>C</i> ; <i>B</i> owns 70% of <i>C</i> .
During 1934,	<i>A</i> owns 80% of <i>B</i> and 25% of <i>C</i> ; <i>B</i> owns 75% of <i>C</i> .

Company *A*'s control of Company *C* is therefore based largely upon its ownership of the stock of the minor parent company, *B*, but partly upon direct ownership of the stock of Company *C*. The illustration comprises the following statements and working papers:

- (A) *On the assumption that the parent companies take up their percentages of the profits, losses, and dividends of the subsidiaries:*

Pages 312 and 313.—A statement of the Surplus and Investment accounts of the three companies.

Note that, in 1931, Company *B* takes up 70% of the profit of Company *C*, or \$4,200.00; Company *A* thereupon takes up 60% of this \$4,200.00 by a debit to Investment in Company *B* and a credit to Surplus.

In 1932, Company *A* takes up (by a debit to Investment in Company *B*) 60% of the \$1,400.00 taken up by Company *B*. But, since Company *A* now owns 20% of the stock of Company *C*, it also takes up 20% of Company *C*'s \$2,000.00 profit, or \$400.00, by a debit to Investment in Company *C*. (Since the 20% interest is a minor-

COMPANY A AND SUBSIDIARIES B AND C
Statement of Surplus and Investment Accounts
(Subsidiary Profits, Losses, and Dividends Taken Up)

	COMPANY B			COMPANY A					
	Com- pany C Surplus	Investment In Company C Per Cent	Amount	Surplus	Investment In Company C Per Cent	Amount	Investment In Company B Per Cent	Amount	Surplus
1928: Purchase—December 31.....				\$50,000			60 %	\$100,000	\$150,000
1929: Profits: Company B.....				15,000				9,000	9,000
Company A.....									25,000
Dividends: Company B.....				6,000*				3,600*	
Company A.....									9,000*
Balances.....				\$59,000			60 %	\$105,400	\$175,000
1930: Profits: Company B.....				12,000				7,200	7,200
Company A.....									20,000
Dividends: Company B.....				6,000*				3,600*	
Company A.....									9,000*
Purchase—December 31.....									
Balances.....	\$30,000	70 %	\$60,000				60 %	\$109,000	\$193,200
1931: Profits: Company C (see comment, page 311).....	\$30,000	70 %	\$60,000	\$4,200				2,520	2,520
Company B.....	6,000		4,200					6,000	6,000
Company A.....				10,000					15,000
Dividends: Company C.....	3,000*		2,100*					3,600*	
Company B.....				6,000*					9,000*
Company A.....									
Purchase—December 31.....							20 %	\$18,000	
Balances.....	\$33,000	70 %	\$62,100	\$73,200			20 %	\$113,920	\$207,720

1932: Profits: Company C (see comment, page 311).....	2,000	1,400	1,400	400	840	1,240
Company B.....			5,000		3,000	3,000
Company A.....						10,000
Dividends: Company C.....	3,000*	2,100*	6,000*	600*	3,600*	9,000*
Company B.....						
Company A.....						
Purchase—December 31.....					36,000	
Balances.....	<u>\$32,000</u>	<u>\$61,400</u>	<u>\$73,600</u>	<u>\$17,800</u>	<u>\$150,160</u>	<u>\$212,960</u>
1933: Profits (Losses*): Company C.....	3,000*	2,100*	2,100*	600*	1,680*	2,280*
Company B.....			2,000*		1,600*	1,600*
Company A.....						5,000
Dividends: Company C.....	3,000*	2,100*	6,000*	600*	4,800*	9,000*
Company B.....						
Company A.....						
Purchase—December 31.....						
Balances.....	<u>\$26,000</u>	<u>4,000</u>	<u>\$63,500</u>	<u>4,000</u>	<u>\$142,080</u>	<u>\$205,080</u>
1934: Losses: Company B.....	2,000*	\$61,200	1,500*	\$20,600	1,200*	1,700*
Company A.....		1,500*	4,000*	500*	3,200*	3,200*
Dividends: Company C.....	3,000*	2,250*	6,000*	750*	4,800*	3,000*
Company B.....						
Company A.....						
Balances.....	<u>\$21,000</u>	<u>\$57,450</u>	<u>\$52,000</u>	<u>\$19,350</u>	<u>\$132,880</u>	<u>\$188,180</u>

* Deductions.

ity holding, the entry would not be justified except for the fact that Company *A* exercises control of Company *C* through the minor parent company, *B*.) Company *A* credits its Surplus account with \$1,240.00, to offset the debits to the two Investment accounts.

Adjustments with respect to the profits and losses of Company *C* in subsequent years are made in a similar manner.

Page 315.—Consolidated balance sheet working papers.

(B) *On the assumption that the parent companies carry the investments at cost:*

Page 316.—A statement of the Surplus and Investment accounts of the three companies.

Each company takes up the subsidiary dividends as income. Company *A* makes no entry for the dividends received by Company *B* from Company *C*.

Page 317.—Work sheet to determine adjustments of Surplus and Investment accounts of major and minor parent companies.

Note that Company *B* adjusts its accounts for its percentage of the change in the surplus of Company *C*. Company *A* adjusts its Investment in *C* for its 20% (later 25%) interest in the change in the surplus of Company *C*; it adjusts its Investment in *B* for its percentage of the change in *B*'s surplus and its percentage of *B*'s adjustments.

Page 318.—Consolidated balance sheet working papers.

Note the application of the adjustments determined in the work sheet on page 317. The eliminations are the same as those in the working papers on page 315.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Balance Sheet Working Papers

December 31, 1934

(Subsidiary Profits, Losses, and Dividends Taken Up)

	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>	<u>Eliminations</u>	<u>Minority</u>	<u>Consolidated</u>
Assets						
Cash.....	60,000 00	20,150.00	15,000.00			95,150.00
Accounts Receivable.....	90,000 00	50,000.00	40,000.00			180,000.00
Inventories.....	60,950.00	49,400.00	41,000.00			151,350.00
Investment in Company B—80% Eliminate:	132,880.00			80,000 00(a) 41,600.00(c)		11,280.00G
Capital Stock.....						
Surplus.....						
Goodwill.....						
Investment in Company C—25% Eliminate:	19,350.00			12,500 00(b) 5,250.00(d)		1,600.00G
Capital Stock.....						
Surplus.....						
Goodwill.....						
Investment in Company C—75% Eliminate:		57,450.00		37,500 00(b) 15,750.00(d)		4,200 00G
Capital Stock.....						
Surplus.....						
Goodwill.....	<u>363,180 00</u>	<u>177,000 00</u>	<u>96,000 00</u>	<u>192,600 00</u>		<u>443,580 00</u>
Liabilities						
Accounts Payable.....	25,000.00	25,000.00	25,000.00			75,000.00
Capital Stock:						
Company A.....	150,000.00					
Company B.....		100,000.00				
Company C.....			50,000.00	80,000 00(a) 50,000.00(b)	20,000.00	150,000.00
Surplus:						
Company A.....	188,180.00					188,180.00
Company B.....		52,000.00		41,600 00(c)	10,400.00	
Company C.....			21,000.00	21,000.00(d)		
Minority Interest.....	<u>363,180 00</u>	<u>177,000 00</u>	<u>96,000 00</u>	<u>192,600 00</u>	<u>30,400 00</u>	<u>30,400 00</u>
						<u>443,580 00</u>

COMPANIES A, B, AND C
Statement of Surplus and Investment Accounts
(Investments Carried at Cost)

	COMPANY B			COMPANY A		
	Investment In Company C		Surplus	Investment In Company C		Surplus
	Per Cent	Cost		Per Cent	Cost	
1928: Purchase—December 31.....						
1929: Profits.....			\$50,000.00			\$150,000.00
Dividends: Company B.....			15,000.00		\$100,000.00	25,000.00
Company A.....			6,000.00*			3,600.00
1930: Balances.....			\$69,000.00			\$9,000.00*
Profits: Company B.....			12,000.00			20,000.00
Dividends: Company A.....			6,000.00*			3,600.00
Purchase—December 31.....					\$100,000.00	
1931: Balances.....			\$80,000.00			\$169,600.00
Profits: Company C.....	70 %	\$60,000.00				20,000.00
Dividends: Company C.....	70 %	\$60,000.00				3,600.00
Company B.....						9,000.00*
Purchase—December 31.....					\$100,000.00	
1932: Balances.....			\$71,100.00			\$184,200.00
Profits: Company C.....	70 %	\$60,000.00				15,000.00
Dividends: Company C.....			5,000.00			3,600.00
Company A.....			2,100.00			9,000.00*
Purchase—December 31.....			6,000.00*	20 %	\$18,000.00	
1933: Balances.....			\$72,200.00			\$193,800.00
Profits (Losses*).....			2,000.00*	20 %	\$18,000.00	10,000.00
Dividends: Company C.....			2,100.00			600.00
Company B.....			6,000.00*			3,600.00
Purchase—December 31.....				20 %	\$18,000.00	
1934: Balances.....			\$72,200.00			\$199,000.00
Profits (Losses*).....			2,000.00*	80 %	\$136,000.00	5,000.00
Dividends: Company B.....			2,250.00			600.00
Company C.....			6,000.00*			4,800.00
Purchase—December 31.....				5	4,000.00	
1935: Balances.....			\$68,300.00			\$200,400.00
Profits (Losses*).....			2,000.00*	25 %	\$22,000.00	3,000.00*
Dividends: Company B.....			2,250.00			750.00
Company C.....			6,000.00*			4,800.00
Purchase—December 31.....				25 %	\$22,000.00	
1936: Balances.....			\$68,300.00			\$193,950.00
Deductions.....				25 %	\$22,000.00	

* Deductions.

**Work Sheet to Determine Adjustments
of Parent Companies' Surplus and Investment Accounts
(Investments Carried at Cost)**

Acquisition Dates	SUBSIDIARIES' SURPLUS ACCOUNTS—PER BOOKS		COMPANY B		COMPANY A	
	Company C	Company B	Investment In Company C	Investment In Company B	Investment In Company C	Investment In Company B
	Amount	Amount	Per Cent	Amount	Per Cent	Amount
Dec. 31, 1928—A buys 60 % of B.....		\$50,000				\$9,000
1929-1930—Increase.....		15,000				
Dec. 31, 1930—B buys 70 % of C.....	\$30,000	\$65,000	70 %	\$2,100		1,260
1931: Increase—Co. C.....	3,000					3,660
Increase—Co. B.....		6,100				
Dec. 31, 1931—A buys 20 % of C.....	\$33,000	\$71,100	70	700*	\$ 200*	420*
1932: Decrease—Co. C..	1,000*					660
Increase—Co. B..		1,100				
Dec. 31, 1932—A buys 20 % of B.....	\$32,000	\$72,200	70	4,200*	1,200*	3,360*
1933: Decrease—Co. C..	6,000*					4,720*
Decrease—Co. B..		5,900*				
Dec. 31, 1933—A and B each buy 5 % of C	\$26,000	\$66,300	75	3,750*	1,250*	3,000*
1934: Decrease—Co. C..	5,000*					6,200*
Decrease—Co. B..		7,750*				
Balances—December 31, 1934.....	\$21,000	\$58,550				
Total Adjustments: Company B.....		6,550*		\$6,550*		\$3,120*
Company A.....						
Adjusted Balances.....	\$21,000	\$52,000				
Eliminations:						
A's 25 % and 80 %.....	\$ 5,250	\$41,600				
B's 75 %.....	15,750					
Minority Interest—20 %.....	10,400					
	\$21,000	\$52,000				

* Deductions.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Balance Sheet Working Papers

December 31, 1934

(Investments Carried at Cost)

Assets	Company A	Company B	Company C	Adjustments		Eliminations	Minority	Consolidated
				Debit	Credit			
Cash.....	60,000.00	20,150.00	15,000.00					95,150.00
Accounts Receivable.....	90,000.00	50,000.00	40,000.00					180,000.00
Inventories.....	60,950.00	49,400.00	41,000.00					151,350.00
Investment in Company B—80%—Cost.....	136,000.00				3,120.00(A)			
Adjustment.....								
Eliminate:								
Capital Stock.....						80,000.00(a)		
Surplus.....						41,600.00(c)		
Goodwill.....								11,280.00G
Investment in Company C—25%—Cost.....	22,000.00				2,650.00(A)			
Adjustment.....								
Eliminate:								
Capital Stock.....						12,500.00(b)		
Surplus.....						5,250.00(d)		
Goodwill.....		64,000.00						1,600.00G
Investment in Company C—75%—Cost.....								
Adjustment.....								
Eliminate:								
Capital Stock.....						37,500.00(b)		
Surplus.....						15,750.00(d)		
Goodwill.....						<u>192,600.00</u>		<u>4,200.00G</u>
	<u>368,950.00</u>	<u>183,550.00</u>	<u>96,000.00</u>					<u>443,580.00</u>
Liabilities								
Accounts Payable.....	25,000.00	25,000.00	25,000.00					75,000.00
Capital Stock:								
Company A.....	150,000.00							
Company B.....		100,000.00					20,000.00	
Company C.....			50,000.00					
Surplus:								
Company A.....	193,950.00							
Company B.....		58,550.00						
Company C.....			21,000.00				10,400.00	
Minority Interest.....							<u>30,400.00</u>	<u>30,400.00</u>
	<u>368,950.00</u>	<u>183,550.00</u>	<u>96,000.00</u>	<u>12,320.00</u>	<u>12,320.00</u>	<u>192,600.00</u>		<u>443,580.00</u>

Fifth illustration : Reciprocal stockholdings.—In this illustration, Company *A* holds controlling interests in Companies *B* and *C*. Company *B* holds 15% (and later 20%) of the stock of Company *C*. Company *C* holds 20% (and later 30%) of the stock of Company *B*. These reciprocal stockholdings between *B* and *C* involve certain complications in the computation of the amounts of intercompany profits to be taken up. The illustration comprises the following statements, working papers, and comments :

(A) *On the assumption that subsidiary profits, losses, and dividends are taken up by the parent companies:*

Pages 320 and 321.—Statement of Surplus and Investment accounts on the books of the three companies.

Pages 322 and 323.—Comments on computation of profits taken up. Especial attention is directed to these comments because they illustrate and explain the algebraic computation that is required for the determination of profits applicable to intercompany stockholdings.

Page 324.—Consolidated balance sheet working papers. (Note the Goodwill column for assembling the various goodwill elements.)

Page 325.—Proof of the goodwill elements in the various stock purchases.

(B) *On the assumption that the investments are carried at cost:*

Page 326.—Statement of Surplus and Investment accounts on the books of the three companies.

Each company merely takes up the dividends received from its subsidiaries.

Page 327.—Work sheet to determine adjustments of Surplus and Investment accounts.

Pages 328 and 329.—Comments on the adjustments in the work sheet.

Page 330.—Consolidated balance sheet working papers.

COMPANY A AND SUBSIDIARIES B AND C
Statement of Surplus and Investment Accounts
(Subsidiary Profits, Losses, and Dividends Taken Up)

	COMPANY C			COMPANY B			COMPANY A		
	Investment In Company C		Surplus	Investment In Company B		Surplus	Investment In Company A		Surplus
	Per Cent	Amount		Per Cent	Amount		Per Cent	Amount	
Dec. 31, 1929—A buys 60 % of B									
1930: Profits: Company B.....			\$50,000.00			60 %	\$ 95,000.00	\$100,000.00	
Company A.....			15,000.00				9,000.00	9,000.00	
Dividends: Company B.....			6,000.00*				3,600.00*	25,000.00	
Company A.....								12,000.00*	
Dec. 31—A buys 70 % of C			\$60,000.00			70 %	\$115,000.00	\$122,000.00	
Balances.....			\$60,000.00			70 %	\$115,000.00	7,000.00	
1931: Profits: Company C.....			10,000.00				7,000.00	9,000.00	
Company B.....								9,000.00	
Dividends: Company C.....			6,000.00*				4,200.00*	25,000.00	
Company B.....									
Company A.....								12,000.00*	
Dec. 31—B buys 15 % of C			\$64,000.00			15 %	\$25,000.00	\$151,000.00	
Balances.....			10,000.00			15 %	\$25,000.00	7,900.00	
1932: Profits: Company C.....			10,000.00				1,500.00	9,000.00	
Company B.....								9,000.00	
Dividends: Company C.....			6,000.00*				900.00*	25,000.00	
Company B.....									
Company A.....								12,000.00*	
Dec. 31—C buys 20 % of B			\$68,000.00			20 %	\$36,000.00	\$180,900.00	
Balances.....			\$68,000.00			20 %	\$36,000.00	\$180,900.00	

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Comments on computation of profits taken up by parent companies (as shown in the statement on page 320).—The profits taken up by the parent companies are computed as follows:

1930—Company *A* owns 60% of the stock of Company *B*, and takes up 60% of Company *B*'s \$15,000.00 profit, or \$9,000.00.

1931—Company *A* owns 60% of the stock of Company *B*, and takes up 60% of its profit. *A* owns 70% of the stock of Company *C*, and takes up 70% of its profit.

1932—Company *B* owns 15% of the stock of Company *C*, and takes up 15% of its profit, or \$1,500.00.

Company *A* owns 60% of the stock of Company *B*, and takes up 60% of *B*'s \$15,000.00 profit, or \$9,000.00; it also takes up 60% of the \$1,500.00 (Company *C* profit) taken up by Company *B*.

Company *A* owns 70% of the stock of Company *C*, and takes up 70% of its profit, or \$7,000.00.

1933—The intercompany holdings are as follows:

A owns 60% of *B*.

A owns 70% of *C*.

B owns 15% of *C*.

C owns 20% of *B*.

The profits of Companies *B* and *C* are affected by their reciprocal stockholdings. That is, Company *B*'s profits were \$15,000.00 plus its 15% of the profits of Company *C*; and Company *C*'s profits were \$10,000.00 plus its 20% interest in the profits of Company *B*. The profits of the two companies are therefore determined as follows:

Let *B* = Profits of Company *B*

Let *C* = Profits of Company *C*

Then $B = \$15,000.00 + .15 C$

$C = \$10,000.00 + .20 B$

$C = \$10,000.00 + .2 (\$15,000.00 + .15 C)$

$C = \$10,000.00 + \$3,000.00 + .03 C$

$.97C = \$13,000.00$

$C = \$13,402.06$

Since *C*'s profits from its own operations were \$10,000.00, the addition to be made on account of intercompany profits is \$13,402.06 minus \$10,000.00, or \$3,402.06.

PURCHASES AND SALES OF SUBSIDIARY STOCK 323

Note *C*'s debit to Investment in Company *B* and credit to Surplus for this amount.

$$\begin{aligned} B &= \$15,000.00 + .15 C \\ B &= \$15,000.00 + (.15 \text{ of } \$13,402.06) \\ B &= \$15,000.00 + \$2,010.31 = \$17,010.31 \end{aligned}$$

Company *B*'s adjustment for intercompany profits is \$2,010.31. Note *B*'s debit to Investment in *C* and credit to Surplus for this amount.

Company *A* owns 70% of the stock of Company *C*; it therefore takes up 70% of Company *C*'s profit of \$13,402.06, or \$9,381.44. Company *A* owns 60% of the stock of Company *B*; it therefore takes up 60% of Company *B*'s profit of \$17,010.31, or \$10,206.19.

1934—The intercompany stockholdings are:

- A* owns 65% of *B*.
- A* owns 70% of *C*.
- B* owns 20% of *C*.
- C* owns 30% of *B*.

The profits of *B* and *C* are computed as follows:

$$\begin{aligned} B's \text{ profit} &= B = \$15,000.00 + .20 C \\ C's \text{ profit (loss)} &= C = -\$8,000.00 + .30 B \\ \text{Then } C &= -\$8,000.00 + .30 (\$15,000.00 + .20 C) \\ C &= -\$8,000.00 + \$4,500.00 + .06 C \\ .94C &= -\$3,500.00 \\ C &= -\$3,723.40 \end{aligned}$$

Since *C*'s loss from its own operations was \$8,000.00 and its loss after taking up its share of *B*'s profit is \$3,723.40, the share of *B*'s profit taken up was \$4,276.60. Note adjustment of accounts on *C*'s books.

$$\begin{aligned} B &= \$15,000.00 + .20 C \\ &= \$15,000.00 + (.2 \text{ of } -\$3,723.40) \\ &= \$15,000.00 - \$744.68 \\ &= \$14,255.32 \end{aligned}$$

B takes up \$744.68 as its share of *C*'s loss. Note adjustment of accounts on *B*'s books.

Company *A* owns 65% of the stock of Company *B*, and takes up 65% of *B*'s profit of \$14,255.32, or \$9,265.96. Company *A* owns 70% of the stock of Company *C*, and takes up 70% of its \$3,723.40 loss, or \$2,606.38.

324 PURCHASES AND SALES OF SUBSIDIARY STOCK

COMPANY A AND SUBSIDIARIES B AND C
 Consolidated Balance Sheet Working Papers
 December 31, 1934
 (Subsidiary Profits, Losses, and Dividends Taken Up)

Assets	Company A	Company B	Company C	Eliminations	Good- will	Consoli- dated Balance Sheet
Cash.....	25,100.00	20,000.00	15,000.00			60,100.00
Accounts Receivable.....	50,000.00	69,000.00	30,000.00			149,000.00
Inventories.....	125,000.00	90,000.00	75,000.00			290,000.00
Investment in Company B—65 % Eliminate: Capital Stock Surplus.....	134,072.15			65,000.00(A) 63,547.66(C)	5,524.49	
Goodwill.....						
Investment in Company C—70 % Eliminate: Capital Stock Surplus.....	118,975.06			70,000.00(B) 45,975.06(D)	3,000.00	
Goodwill.....		33,765.63				
Investment in Company C—20 % Eliminate: Capital Stock Surplus.....				20,000.00(B) 13,135.73(D)	629.90	
Goodwill.....			60,678.66			
Investment in Company B—30 % Eliminate: Capital Stock Surplus.....				30,000.00(A) 29,329.69(C)	1,348.97 20,000.00	
Goodwill.....	10,000.00	5,000.00	5,000.00			30,503.36 <u>529,603.36</u>
Goodwill.....					Minority	70,000.00
Total Goodwill.....	<u>463,147.21</u>	<u>217,765.63</u>	<u>185,678.66</u>	<u>336,988.14</u>		<u>26,456.15</u> <u>529,603.36</u>
Liabilities						
Accounts Payable.....	30,000.00	20,000.00	20,000.00			200,000.00
Capital Stock:						
Company A.....	200,000.00			95,000.00(A)	5,000.00	5,000.00
Company B.....		100,000.00		90,000.00(B)	10,000.00	10,000.00
Company C.....			100,000.00			
Surplus:						
Company A.....	233,147.21			92,877.35(C) 59,110.79(D)	4,888.28 6,567.87	233,147.21
Company B.....		97,765.63				
Company C.....			65,678.66			
Total Minority Interest.....	<u>463,147.21</u>	<u>217,765.63</u>	<u>185,678.66</u>	<u>336,988.14</u>		<u>26,456.15</u> <u>529,603.36</u>

Proof of Goodwill Elements in Stock Purchases
(As Shown in the Consolidated Working Papers on Page 324)
STOCK AND SURPLUS OF
SUBSIDIARY AT
ACQUISITION

	<u>Total</u>	<u>Amount Acquired</u>	<u>Cost of Stock</u>	<u>Goodwill</u>
A's investment in B:				
Purchase of December 31, 1929—60 %	\$150,000.00	\$ 90,000.00	\$ 95,000.00	\$5,000.00
Purchase of December 31, 1933— 5 %	189,510.31	9,475.51	10,000.00	524.49
Total				<u>\$5,524.49</u>
A's investment in C:				
Purchase of December 31, 1930—70 %	160,000.00	112,000.00	115,000.00	\$3,000.00
B's investment in C:				
Purchase of December 31, 1931—15 %	164,000.00	24,600.00	25,000.00	\$ 400.00
Purchase of December 31, 1933— 5 %	175,402.06	8,770.10	9,000.00	229.90
Total				<u>\$ 629.90</u>
C's investment in B:				
Purchase of December 31, 1932—20 %	178,500.00	35,700.00	36,000.00	\$ 300.00
Purchase of December 31, 1933—10 %	189,510.31	18,951.03	20,000.00	1,048.97
Total				<u>\$1,348.97</u>

COMPANY A AND SUBSIDIARIES B AND C
Statement of Surplus and Investment Accounts
(Investments Carried at Cost)

	COMPANY C			COMPANY B			COMPANY A		
	Investment In Company C		Surplus	Investment In Company B		Surplus	Investment In Company A		Surplus
	Per Cent	Cost		Per Cent	Cost		Per Cent	Cost	
December 31, 1929—A buys 60 % of B									
1930: Profits			\$60,000			\$50,000			\$100,000
Dividends: Company B			15,000			15,000			25,000
Company A			6,000*			6,000*			12,000*
December 31—A buys 70 % of C									
Balances			\$60,000			\$59,000			\$115,600
1931: Profits			10,000			15,000			25,000
Dividends: Company C			6,000*			6,000*			4,200
Company B									3,600
Company A									12,000*
December 31—B buys 15 % of C									
Balances			\$64,000	15 %	\$25,000	\$88,000	60 %	\$95,000	\$137,400
1932: Profits			10,000	15 %	\$25,000	15,000	60 %	\$95,000	25,000
Dividends: Company C			6,000*			900			4,200
Company B						6,000*			3,600
Company A									12,000*
December 31—C buys 20 % of B	20 %	\$36,000							
Balances	20 %	\$36,000	\$68,000	15 %	\$25,000	\$77,900	60 %	\$95,000	\$158,200
1933: Profits			10,000			15,000			25,000
Dividends: Company C			6,000*			900			4,200
Company B			1,200			6,000*			3,600
Company A									12,000*
December 31—C buys 10 % of B	10	20,000		5	9,000		5	10,000	
Balances	30 %	\$56,000	\$73,200	20 %	\$34,000	\$87,800	65 %	\$105,000	\$179,000
1934: Profits			8,000*			15,000			25,000
Dividends: Company C			6,000*			1,200			4,200
Company B			1,800			6,000*			3,900
Company A									12,000*
Balances	30 %	\$56,000	\$61,000	20 %	\$34,000	\$98,000	65 %	\$105,000	\$200,100

* Deduction.

**Work Sheet to Determine Adjustments of Parent Companies'
Surplus and Investment Accounts**

Acquisition Dates	SUBSIDIARY SURPLUS ACCOUNTS		COMPANY C		COMPANY B		COMPANY A		
	Company C	Company B	Investment In Company B	Per Cent	Investment In Company C	Per Cent	Investment In Company C	Per Cent	
	Company C	Company B	Company B	Amount	Company C	Amount	Company C	Amount	
Dec. 31, 1929—A buys 60 % of B.....		\$50,000.00						60 %	\$ 5,400.00
Increase—1930.....		9,000.00							
Dec. 31, 1930—A buys 70 % of C.....	\$60,000.00								
Increase—Company C.....	4,000.00							70 %	\$2,800.00
Increase—Company B.....		9,000.00							
Dec. 31, 1931—B buys 15 % of C.....	\$64,000.00								
Increase—Company C.....	4,000.00				15 %	\$ 600.00		70	2,800.00
Increase—Company B.....		9,900.00							
Dec. 31, 1932—C buys 20 % of B.....	\$68,000.00								
Increase—Company C.....	5,200.00			20 %	\$2,202.06			15	1,110.31
Increase—Company B.....		9,900.00							
Dec. 31, 1933—C buys 10 % of B.....	\$73,200.00								
B buys 5 % of C.....		\$87,800.00							
A buys 5 % of B.....									
Decree—Company C.....	12,200.00*								
Increase—Company B ..		10,200.00		30	2,476.60			20	1,944.68*
Balances—December 31, 1934.....	\$61,000.00	\$98,000.00							6,806.38*
Adjustments.....	4,678.66	234.37*							\$ 234.37*
Adjusted Balances.....	\$65,678.66	\$97,765.63			\$4,678.66				\$3,975.06
Company A's 70 % and 65 %	\$45,975.06	\$63,547.66							
Company B's 20 %	13,135.73								
Company C's 30 %	29,329.69								
Total Elimination.....	\$59,110.79	\$92,877.35							
Minority—10 % and 5 %	6,567.87	4,888.28							
Total.....	\$65,678.66	\$97,765.63							

* Deduction.

328 PURCHASES AND SALES OF SUBSIDIARY STOCK

Comments on the adjustments in the work sheet.—The amounts of the annual adjustments are computed as follows:

1930—Company *A* owned 60% of Company *B*; therefore the adjustment is for 60% of the \$9,000.00 increase in Company *B*'s surplus.

1931—Company *A* owned 70% of Company *C* and 60% of *B*; the adjustments are therefore 70% and 60%, respectively, of the \$4,000.00 and \$9,000.00 increases in surplus.

1932—Company *B* takes up 15% of the \$4,000.00 increase in Company *C*'s surplus, or \$600.00; Company *A*, because of its 60% interest in Company *B*, takes up 60% of the \$600.00 taken up by Company *B*. Company *A*, because of its 70% interest in Company *C*, takes up 70% of the \$4,000.00 increase in Company *C*'s surplus. Company *A* also takes up 60% of the \$9,900.00 increase in the surplus of Company *B*.

1933—Because of the reciprocal stockholdings between Companies *C* and *B*, the adjustments are computed as follows:

$$\begin{aligned}
 C &= \$5,200.00 + .20B = \text{Increase in surplus of Company } C \\
 B &= \$9,900.00 + .15C = \text{Increase in surplus of Company } B \\
 C &= \$5,200.00 + .20(\$9,900.00 + .15C) \\
 &= \$5,200.00 + \$1,980.00 + .03C \\
 .97C &= \$7,180.00 \\
 C &= \$7,402.06 \\
 B &= \$9,900.00 + .15C \\
 &= \$9,900.00 + (.15 \times \$7,402.06) \\
 &= \$9,900.00 + \$1,110.31 \\
 &= \$11,010.31
 \end{aligned}$$

Then *C*'s 20% of the increase in *B*'s surplus is 20% of \$11,010.31, or \$2,202.06.

B's 15% of the increase in *C*'s surplus is 15% of \$7,402.06, or \$1,110.31.

A's 70% of the increase in *C*'s surplus is 70% of \$7,402.06, or \$5,181.44.

A's 60% of the increase in *B*'s surplus is 60% of \$11,010.31, or \$6,606.19.

1934—Again, the reciprocal stockholdings require the computation of the adjustments algebraically:

$$\begin{aligned}
 C &= -\$12,200.00 + .30B \\
 B &= \$10,200.00 + .20C \\
 C &= -\$12,200.00 + .3(\$10,200.00 + .2C) \\
 &= -\$12,200.00 + \$3,060.00 + .06C
 \end{aligned}$$

PURCHASES AND SALES OF SUBSIDIARY STOCK 329

$$\begin{aligned} .94C &= -\$9,140.00 \\ C &= -\$9,723.40, \text{ Decrease in surplus of Company } C \\ B &= \$10,200.00 + .20C \\ &= \$10,200.00 + (.2 \times -\$9,723.40) \\ &= \$10,200.00 - \$1,944.68 \\ &= \$8,255.32 \end{aligned}$$

Then C 's 30% of the increase in B 's surplus is 30% of \$8,255.32,
or \$2,476.60.

B 's 20% of the decrease in C 's surplus is 20% of \$9,723.40,
or \$1,944.68.

A 's 70% of the decrease in C 's surplus is 70% of \$9,723.40,
or \$6,806.38.

A 's 65% of the increase in B 's surplus is 65% of \$8,255.32,
or \$5,365.96.

The consolidated working papers appear on the following page.

330 PURCHASES AND SALES OF SUBSIDIARY STOCK

COMPANY A AND SUBSIDIARIES B AND C Consolidated Balance Sheet Working Papers

December 31, 1934

(Investments Carried at Cost)

Assets	Company A	Company B	Company C	Adjustments (Add— Deduct)*	Eliminations	Goodwill	Consoli- dated Balance Sheet
Cash.....	95,100.00						95,100.00
Accounts Receivable.....	50,000.00	20,000.00	15,000.00				149,000.00
Inventories.....	30,000.00	69,000.00	30,000.00				290,000.00
Investment in Company B—65%—Cost.....	125,000.00	90,000.00	75,000.00	29,072.15 (1)			
Eliminate: Capital Stock.....	105,000.00				65,000.00(A) 63,547.66(C)		
Goodwill.....						5,524.49	
Investment in Company C—70%—Cost.....	115,000.00			3,975.06 (1)	70,000.00(B) 45,975.06(D)		
Eliminate: Capital Stock.....						3,000.00	
Goodwill.....							
Investment in Company C—20%—Cost.....		34,000.00		234.37*(2)	20,000.00(B) 13,135.73(D)		
Eliminate: Capital Stock.....						629.90	
Goodwill.....			58,000.00	4,678.66 (3)	30,000.00(A) 29,329.69(C)		
Investment in Company B—30%—Cost.....							
Eliminate: Capital Stock.....						1,348.97 20,000.00	
Goodwill.....	10,000.00	5,000.00	5,000.00			30,503.36	30,503.36
Goodwill.....							<u>529,603.36</u>
Total Goodwill.....	<u>430,100.00</u>	<u>218,000.00</u>	<u>181,000.00</u>	<u>37,491.50</u>	<u>336,988.14</u>	Minority	
							70,000.00
Accounts Payable.....	30,000.00	20,000.00	20,000.00				200,000.00
Capital Stock:							
Company A.....	200,000.00						
Company B.....		100,000.00					
Company C.....			100,000.00				
Surplus:							
Company A.....	200,100.00			33,047.21 (1)			233,147.21
Company B.....		98,000.00		234.37*(2)			4,888.28
Company C.....			61,000.00	4,678.66 (3)			6,567.87
Total Minority Interest.....						26,456.15	
	<u>430,100.00</u>	<u>218,000.00</u>	<u>181,000.00</u>	<u>37,491.50</u>	<u>336,988.14</u>		<u>529,603.36</u>

CHAPTER 49

CONSOLIDATED BALANCE SHEET, SURPLUS STATEMENT, PROFIT AND LOSS STATEMENT, AND SUPPORTING STATEMENTS

Working Papers : General Form

The consolidated balance sheet is frequently accompanied by a consolidated surplus statement, a consolidated profit and loss statement, and supporting statements such as a statement of cost of goods sold and schedules of expenses.

Before studying the detailed illustrations in this chapter, the student should note the general organization of the working papers in which the data for these statements are assembled. Refer, therefore, to the working papers on pages 334 and 335, and note the following matters:

A separate section of the working papers is devoted to each consolidated statement to be prepared.

The following columns are used:

- Company statements —one column each.
- Adjustments and eliminations—two columns.
- Minority interest —one column.
- Consolidated statements —one column.

Balances are forwarded from one section of the working papers to a succeeding section, thus:

Cost of goods sold—forwarded from the Cost of Goods Sold section to the Profit and Loss section.

Net income—forwarded from the Profit and Loss section to the Surplus section.

Surplus at end of period—forwarded from the Surplus section to the Liabilities and Net Worth section.

Outline of Illustrations

Four principal illustrative cases are presented in this chapter, and consolidated statements are required for the year ended December 31, 1934. In each of these cases it is

assumed that Company *P* owns 90% of the stock of Company *S*, which Company *P* acquired on January 1, 1932; the surplus of Company *S* at the date of acquisition was \$10,000.00. The four cases differ as follows:

First and second illustrations.—The parent company has taken up its share of subsidiary profits, losses, and dividends through the Investment account:

First illustration: No dividends were paid during 1934.

Second illustration: Dividends were paid during 1934.

Third and fourth illustrations.—The parent company is carrying the investment at cost:

Third illustration: No dividends were paid during 1934.

Fourth illustration: Dividends were paid during 1934.

First and second illustrations.—In the first two illustrations it is assumed that the parent company has taken up its share of subsidiary profits, losses, and dividends through the Investment account. The two illustrations differ only in the matter of dividends during 1934, the year for which the statements are being prepared.

First illustration. (*See working papers, pages 334 and 335.*)—The working papers for this illustration contain adjustments and eliminations described in detail in the following paragraphs.

Elimination A.—The student is already familiar with the procedure of making eliminations of intercompany balances in consolidated balance sheet working papers. If any nominal accounts contain debits or credits for intercompany transactions, the amounts of such intercompany items must be eliminated in the Cost of Goods Sold, Profit and Loss, or Surplus section of the working papers, so that the consolidated statements will reflect the results of transactions with outsiders only.

During 1934, Company *S* made sales of \$25,000.00 to Company *P*. These were recorded in the Purchases account of Company *P* and in the Sales account of Company *S*. The intercompany sales are eliminated by elimination A, crediting Purchases in the Cost of Goods Sold section, and debiting Sales in the Profit and Loss section.

Elimination B.—Company *S* has \$50,000.00 of capital stock, of which Company *P* owns \$45,000.00. The intercompany

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 333

stockholding is eliminated in the Balance Sheet section, by elimination B, from the Capital Stock account of Company S and from the Investment account of Company P.

Adjustment C.—The first two illustrations do not contain any adjustments bearing this letter. Adjustment C appears only in the third and fourth illustrations.

Elimination D.—This is an elimination with which the student is already familiar; it eliminates the parent company's percentage of the subsidiary surplus.

The credit elimination from the Investment account is made in the usual way. If only a consolidated balance sheet were to be prepared, the offsetting debit would be eliminated from the subsidiary surplus in the balance sheet working papers; but since a consolidated surplus statement and a consolidated profit and loss statement are to be prepared, the debit must be apportioned between the surplus at the beginning of the period (in the surplus papers) and the changes during the period (in the profit and loss papers).

These elements of Company S's surplus, and of Company P's 90% interest therein, are detailed as follows:

	COMPANY S SURPLUS	
	Total	Company P's 90%
Surplus, December 31, 1933.....	\$15,000.00	\$13,500.00
Net Profit, 1934.....	10,000.00	9,000.00
Surplus, December 31, 1934.....	<u>\$25,000 00</u>	<u>\$22,500 00</u>

The elimination of Company P's interest in the surplus of Company S is made as follows:

	Section of Working Papers		
		Debit	Credit
Surplus of Co. S (as of Dec. 31, 1933)....	Surplus	\$13,500	
Company S Profit.....	P. & L.	9,000	
Investment in Stock of Company S....	Assets		\$22,500

The debit to Surplus of Company S eliminates 90% of the subsidiary surplus on December 31, 1933; the parent company's surplus includes its share of the subsidiary's earnings to that date.

The account Company S Profit is the account which Company P credited to take up its share of the income of Company S for 1934; this account balance must be eliminated because we shall carry the balances of the income and expense accounts of Company S to the Consolidated column, and the con-

Working papers for first illustration.

COMPANY P AND SUBSIDIARY S

Consolidated Working Papers

Year Ended December 31, 1934

	Company <u>P</u>	Company <u>S</u>	ADJUSTMENTS AND ELIMINATIONS		Minority	Consoli- dated
			<u>Debit</u>	<u>Credit</u>		
COST OF GOODS SOLD						
Inventory, December 31, 1933.....	25,000.00	15,000.00				40,000.00
Purchases.....	100,000.00	80,000.00		25,000.00(A)		155,000.00
Total.....	125,000.00	95,000.00				195,000.00
Less Inventory, December 31, 1934.....	27,000.00	16,000.00				43,000.00
Cost of Goods Sold (Forward).....	98,000.00	79,000.00		25,000.00		152,000.00
PROFIT AND LOSS						
Sales.....	125,000.00	100,000.00	25,000.00(A)			200,000.00
Less Cost of Goods Sold (Brought forward).....	98,000.00	79,000.00		25,000.00		152,000.00
Gross Profit on Sales.....	27,000.00	21,000.00				48,000.00
Less Expenses.....	15,000.00	11,000.00				26,000.00
Net Profit.....	12,000.00	10,000.00				22,000.00
Company S Profit—90%.....	9,000.00				9,000.00(D)	
Net Profit before Deduction of Minority Interest.....	21,000.00	10,000.00				22,000.00
Minority Interest—10%.....					1,000.00	1,000.00
Net Income (Forward).....	21,000.00	10,000.00	34,000.00	25,000.00		21,000.00

SURPLUS	
Surplus, December 31, 1933:	
Company P.....	39,000.00
Company S.....	15,000.00
Net Income (Brought forward).....	13,500.00(D)
Surplus, December 31, 1934 (Forward).....	34,000.00
	<u>25,000.00</u>
	<u>25,000.00</u>
	<u>2,500.00</u>
	<u>1,500.00</u>
	<u>1,000.00</u>
	<u>60,000.00</u>
	<u>21,000.00</u>
	<u>39,000.00</u>
ASSETS	
Cash.....	29,000.00
Accounts Receivable.....	40,000.00
Inventory.....	16,000.00
Investment in Stock of Company S—90 %	45,000.00(B)
Eliminate:	22,500.00(D)
Capital Stock.....	<u>85,000.00</u>
Surplus.....	<u>85,000.00</u>
Goodwill.....	<u>10,000.00</u>
	<u>182,500.00</u>
	<u>182,500.00</u>
	<u>22,500.00</u>
	<u>100,000.00</u>
	<u>60,000.00</u>
	<u>45,000.00(B)</u>
	<u>47,500.00</u>
	<u>25,000.00</u>
	<u>92,500.00</u>
	<u>92,500.00</u>
	<u>7,500.00</u>
	<u>2,500.00</u>
	<u>5,000.00</u>
	<u>100,000.00</u>
	<u>32,500.00</u>
	<u>200,000.00</u>
	<u>3,000.00</u>
LIABILITIES AND NET WORTH	
Accounts Payable.....	10,000.00
Capital Stock:	22,500.00
Company P.....	100,000.00
Company S.....	45,000.00(B)
Surplus (Brought forward).....	25,000.00
Total Minority Interest.....	92,500.00
	<u>182,500.00</u>
	<u>182,500.00</u>
	<u>7,500.00</u>
	<u>2,500.00</u>
	<u>5,000.00</u>
	<u>100,000.00</u>
	<u>32,500.00</u>
	<u>200,000.00</u>
	<u>3,000.00</u>

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solidated income would be overstated if we also carried to that column the credit balance of the account on Company P's books, representing its share of the income of Company S. The credit to the Investment account is the customary credit, with which the student is already thoroughly familiar.

Working papers: Special features.—The student should study carefully the working papers on pages 334 and 335, to be sure that he understands the following matters:

- (1) The meaning and purpose of each adjustment and elimination.
- (2) The significance of each entry in the Minority column. Note that the \$1,000.00 minority interest in the profits for the year is entered as a deduction in the Consolidated column of the Profit and Loss section, so that the final balance of the Consolidated column will represent the parent company's interest in the total profits for the year. Note also that the total of the Minority column in the Liabilities and Net Worth section is carried to the Consolidated column.
- (3) The procedure of forwarding balances from one section of the working papers to a succeeding section.

Statements for first illustration.—The following statements were prepared from the foregoing working papers.

COMPANY P AND SUBSIDIARY S	<u>Exhibit D</u>
Consolidated Statement of Cost of Goods Sold	
For the Year Ended December 31, 1934	
Inventory, December 31, 1933.....	\$ 40,000.00
Purchases.....	155,000.00
Total.....	<u>\$195,000.00</u>
Less Inventory, December 31, 1934.....	43,000.00
Cost of Goods Sold.....	<u>\$152,000.00</u>

COMPANY P AND SUBSIDIARY S	<u>Exhibit C</u>
Consolidated Statement of Profit and Loss	
For the Year Ended December 31, 1934	
Sales.....	\$200,000.00
Less Cost of Goods Sold (Exhibit D).....	<u>152,000.00</u>
Gross Profit on Sales.....	\$ 48,000.00
Less Expenses.....	26,000.00
Net Income.....	\$ 22,000.00
Less Minority Interest in Subsidiary Profit.....	1,000.00
Consolidated Net Income—Parent Company's Portion.....	<u>\$ 21,000.00</u>

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COMPANY P AND SUBSIDIARY S
Consolidated Surplus Statement

Exhibit B

For the Year Ended December 31, 1934

Surplus, December 31, 1933	\$39,000 00
Add Net Income (Exhibit C).....	21,000 00
Surplus, December 31, 1934	<u>\$60,000 00</u>

COMPANY P AND SUBSIDIARY S
Consolidated Balance Sheet

Exhibit A

December 31, 1934

Assets		Liabilities and Net Worth	
Cash.....	\$ 64,000	Accounts Payable.....	\$ 32,500
Accounts Receivable.....	90,000	Minority Interest.....	7,500
Inventory.....	43,000	Net Worth:	
Goodwill.....	3,000	Capital Stock..	\$100,000
		Surplus (Ex. B)	60,000
			<u>160,000</u>
	<u>\$200,000</u>		<u>\$200,000</u>

Second illustration. (See working papers, page 338.)—The facts on which this illustration is based are the same as those in the first illustration, with one exception: Dividends were paid during 1934. Eliminations A and B are the same as in the first illustration. Adjustment C was not required in the first illustration and is not required in this illustration.

Elimination D.—The elimination of the parent company's percentage of the subsidiary's surplus is slightly different from the corresponding elimination in the first illustration because the subsidiary's surplus has been reduced during the year by the payment of a dividend. The elements affecting the surplus of Company S, and Company P's 90% interest therein, are as follows:

COMPANY S SURPLUS

	Total	Company P's 90%
Surplus, December 31, 1933.....	\$15,000.00	\$13,500.00
Net Profit—1934.....	10,000.00	9,000.00
Dividend Paid.....	3,000.00*	2,700.00*
Surplus, December 31, 1934.....	<u>\$22,000.00</u>	<u>\$19,800.00</u>

* Deductions.

The elimination is made as follows:

	Section	Debit	Credit
Surplus of Co. S (as of December 31, 1933)	Surplus	\$13,500	
Company S Profit.....	P. & L.	9,000	
Dividend Paid.....	Surplus		\$ 2,700
Investment in Stock of Company S.....	Assets		19,800

Working papers for second illustration.

COMPANY P AND SUBSIDIARY S
Consolidated Working Papers—Year Ended December 31, 1934

**ADJUSTMENTS AND
ELIMINATIONS**

	Company P	Company S	Debit	Credit	Mi- nority	Consoli- dated
SURPLUS						
(Cost of Goods Sold and Profit and Loss sections— same as in first illustration.)						
Surplus, December 31, 1933:						
Company P.....	39,000.00				1,500.00	39,000.00
Company S.....		15,000.00	18,500.00(D)		1,000.00	21,000.00
Net Income (Brought forward).....	21,000.00	10,000.00	34,000.00	25,000.00	2,500.00	60,000.00
Total.....	60,000.00	25,000.00				
Less Dividends Paid:						
Company P.....	6,000.00				300.00	6,000.00
Company S.....		3,000.00		2,700.00(D)		
Surplus, December 31, 1934 (Forward).....	<u>54,000.00</u>	<u>22,000.00</u>	<u>47,500.00</u>	<u>27,700.00</u>	<u>2,200.00</u>	<u>54,000.00</u>
ASSETS						
Cash.....	31,700.00	26,000.00				57,700.00
Accounts Receivable.....	50,000.00	40,000.00				90,000.00
Inventory.....	27,000.00	16,000.00				43,000.00
Investment in Company S—90% Eliminate:	67,800.00					
Capital Stock.....				45,000.00(B)		3,000.00
Surplus.....				19,800.00(D)		
Goodwill.....	<u>176,500.00</u>	<u>82,000.00</u>				<u>193,700.00</u>
LIABILITIES AND NET WORTH						
Accounts Payable.....	22,500.00	10,000.00				32,500.00
Capital Stock:						
Company P.....	100,000.00					100,000.00
Company S.....		50,000.00	45,000.00(B)		5,000.00	54,000.00
Surplus (Brought forward).....	54,000.00	22,000.00	47,500.00	27,700.00	2,200.00	7,200.00
Total Minority Interest.....	<u>176,500.00</u>	<u>82,000.00</u>	<u>92,500.00</u>	<u>92,500.00</u>		<u>193,700.00</u>

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Statements for second illustration.—Since this illustration differs from the preceding one only in the payment of dividends, the statements for the two illustrations differ only in the dividends and closing surplus in the surplus statement, and the cash, minority interest, and surplus in the balance sheet.

COMPANY P AND SUBSIDIARY S Exhibit D
Consolidated Statement of Cost of Goods Sold
For the Year Ended December 31, 1934

Inventory, December 31, 1933	\$ 40,000 00
Purchases	155,000 00
Total	<u>\$195,000 00</u>
Less Inventory, December 31, 1934	43,000 00
Cost of Goods Sold	<u>\$152,000 00</u>

COMPANY P AND SUBSIDIARY S Exhibit C
Consolidated Statement of Profit and Loss
For the Year Ended December 31, 1934

Sales	\$200,000 00
Less Cost of Goods Sold (Exhibit D)	<u>152,000 00</u>
Gross Profit on Sales	\$ 48,000 00
Less Expenses	26,000 00
Net Income	<u>\$ 22,000 00</u>
Less Minority Interest in Subsidiary Profit	1,000 00
Consolidated Net Income—Parent Company's Portion	<u>\$ 21,000 00</u>

COMPANY P AND SUBSIDIARY S Exhibit B
Consolidated Surplus Statement
For the Year Ended December 31, 1934

Surplus, December 31, 1933	\$39,000 00
Add Net Income (Exhibit C)	21,000 00
Total	<u>\$60,000 00</u>
Deduct Dividends Paid	6,000 00
Surplus, December 31, 1934	<u>\$54,000 00</u>

COMPANY P AND SUBSIDIARY S Exhibit A
Consolidated Balance Sheet
December 31, 1934

Assets		Liabilities and Net Worth	
Cash	\$ 57,700	Accounts Payable	\$ 32,500
Accounts Receivable	90,000	Minority Interest	7,200
Inventory	43,000	Net Worth:	
Goodwill	3,000	Capital Stock ..	\$100,000
		Surplus (Ex. B) ..	<u>54,000</u>
	<u>\$193,700</u>		<u>154,000</u>
			<u>\$193,700</u>

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Third and fourth illustrations.—The two following illustrations are the same as the first and second illustrations, respectively, with one exception: It is now assumed that the parent company is carrying the subsidiary investment at cost. Eliminations A and B are the same as in the first two illustrations. An adjustment, C, is now necessary to take up the parent company's percentage of the increase in the subsidiary surplus since acquisition. After this adjustment is made, the D eliminations can be made as in the preceding illustrations.

Third illustration. (*See working papers, page 341.*)—In this illustration it is assumed that no dividends were paid during 1934. It is therefore the same as the first illustration, except that the parent company has not taken up its share of the increase in the subsidiary surplus since acquisition. This increase includes the elements detailed in the following summary:

	COMPANY S SURPLUS	
	Total	Company P's 90 %
Increase Prior to Current Year:		
Surplus, December 31, 1933	\$15,000.00	
Surplus at Date of Acquisition	10,000.00	
Increase Prior to Current Year	\$ 5,000.00	\$ 4,500.00
Increase During 1934:		
Net Income	10,000.00	9,000.00
Total	\$15,000.00	\$13,500.00

Adjustment C.—Because the parent company has not taken up these elements of increase in the subsidiary's surplus since the date of acquisition, the parent company's accounts in this illustration differ from those in the first illustration in the following particulars:

Investment in Stock of Company S:		
Balance in first illustration		\$70,500.00
Balance in third illustration		57,000.00
Difference—equal to Company P's share of increase in subsidiary surplus since acquisition		\$13,500.00
Surplus (as of December 31, 1933):		
Balance in first illustration		\$39,000.00
Balance in third illustration		34,500.00
Difference—equal to Company P's share of increase in subsidiary surplus in prior periods		\$ 4,500.00

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 341

Working papers for third illustration.

COMPANY P AND SUBSIDIARY S

Consolidated Working Papers—Year Ended December 31, 1934

	Company		Company S	ADJUSTMENTS AND ELIMINATIONS		Mi- nority	Consoli- dated
	P	S		Debit	Credit		
(Cost of Goods Sold Section—same as in first illustration.)							
PROFIT AND LOSS							
Sales.....	125,000.00		100,000.00				200,000.00
Less Cost of Goods Sold (Brought forward).....	98,000.00		79,000.00	25,000.00(A)	25,000.00		162,000.00
Gross Profit on Sales.....	27,000.00		21,000.00				48,000.00
Less Expenses.....	15,000.00		11,000.00				26,000.00
Net Profit.....	12,000.00		10,000.00				22,000.00
Company S Profit—90%.....				9,000.00(D)	9,000.00(C)		
Net Profit before Deduction of Minority Interest.....	12,000.00		10,000.00			1,000.00	22,000.00
Minority Interest—10%.....						1,000.00	1,000.00
Net Income (Forward).....	12,000.00		10,000.00	34,000.00	34,000.00		21,000.00
SURPLUS							
Surplus, December 31, 1933:							
Company P.....	34,500.00				4,500.00(C)		39,000.00
Company S.....	12,000.00		15,000.00	13,500.00(D)	34,000.00	1,500.00	21,000.00
Surplus—December 31, 1934 (Forward).....	46,500.00		25,000.00	47,500.00	38,500.00	2,500.00	60,000.00
ASSETS							
Cash.....	35,000.00		29,000.00				64,000.00
Accounts Receivable.....	50,000.00		40,000.00				90,000.00
Inventory.....	27,000.00		16,000.00				43,000.00
Investment in Stock of Company S—90%—At Cost.....							
Add 90% of Increase in Company S Surplus.....				13,500.00(C)			
Eliminate:							
Capital Stock.....							
Surplus.....							
Goodwill.....	169,000.00		85,000.00			45,000.00(B)	3,000.00
						22,500.00(D)	200,000.00
LIABILITIES AND NET WORTH							
Accounts Payable.....	22,500.00		10,000.00				32,500.00
Capital Stock:							
Company P.....	100,000.00						100,000.00
Company S.....			50,000.00	45,000.00(E)	38,500.00	5,000.00	60,000.00
Surplus (Brought forward).....	46,500.00		25,000.00	47,500.00		7,500.00	7,500.00
Total Minority Interest.....							
	169,000.00		85,000.00	106,000.00	106,000.00		200,000.00

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Company S Profit:

Balance in first illustration (representing parent company's credit to income for its share of the profit of Company S during 1934).....	\$ 9,000.00
No similar account appears in the working papers of the third illustration.....	—
Difference—equal to Company P's share of the subsidiary's net income for 1934.....	<u>\$ 9,000.00</u>

The parent company's accounts in this illustration can be adjusted to agree with those in the first illustration, by applying the following adjusting entry in the working papers:

	<u>Section</u>	<u>Debit</u>	<u>Credit</u>
Investment in Stock of Company S	Assets	\$13,500.00	
Surplus (as of December 31, 1933)	Surplus		\$4,500.00
Company S Profit.....	P. & L.		9,000.00

The \$13,500.00 debit to the Investment account takes up the parent company's percentage of the total increase in the subsidiary surplus since acquisition; the \$4,500.00 credit to Surplus takes up the parent company's percentage of the increase in the subsidiary surplus prior to the current year; and the \$9,000.00 credit to Company S Profit sets up the account which appeared on the parent company's books in the first illustration as representing the parent company's share of the subsidiary profit for 1934. In other words, by applying this adjustment in the working papers, the parent company's account balances are brought into agreement with those in the first illustration; elimination D is therefore the same as in the first illustration.

Statements for third illustration.—The first and third illustrations are the same except that in the first illustration the parent company took up its share of subsidiary profits, losses, and dividends through the Investment account, whereas in the third illustration the investment was carried at cost. Adjustment C adjusted the accounts of the third illustration to agree with those of the first illustration. Therefore the statements for the third illustration are the same as those for the first illustration. (See pages 336 and 337.)

Fourth illustration.—(See working papers, pages 344 and 345.)—In this illustration it is assumed that dividends were paid during 1934. This illustration is therefore the same as the second illustration, except that the parent company has not taken up its share of the increase in subsidiary surplus since acquisition.

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 343

Adjustment C.—The increase in the subsidiary surplus since acquisition includes the following elements:

	COMPANY S SURPLUS	
	Total	Company P's 90 %
Increase Prior to Current Year:		
Surplus, December 31, 1933.....	\$15,000 00	
Surplus at Date of Acquisition...	10,000 00	
Increase Prior to Current Year	\$ 5,000 00	\$ 4,500.00
Changes During 1934:		
Net Income.....	10,000 00	9,000 00
Less Dividends Paid.....	3,000 00*	2,700.00*
Total.....	\$12,000.00	\$10,800 00

* Deductions.

The adjustments in the working papers are as follows:

	Section	Debit	Credit
Investment in Stock of Company S Assets	Assets	\$10,800 00	
Dividend from Company S	P. & L.	2,700.00	
Surplus (as of December 31, 1933) Surplus	Surplus		\$4,500 00
Company S Profit.....	P. & L.	·	9,000.00

The debit to the Investment account takes up Company A's 90% of the increase in the subsidiary's surplus since the date of acquisition.

Company P has credited Dividend from Company S with the \$2,700.00 dividend received during the year, and regards this amount as income; the adjusting entry debits this account to eliminate it, and sets up, instead, the \$9,000.00 credit to Company S Profit, representing Company P's percentage of the income earned by the subsidiary during the year.

The credit to Surplus takes up, in the surplus of Company P, as of December 31, 1933, 90% of the increase in Company S surplus between the date of acquisition and December 31, 1933.

In other words, by applying this adjustment in the working papers, Company P's accounts are adjusted to agree with those in the second illustration, in which the subsidiary profits, losses, and dividends were taken up currently through the Investment account. The elimination (D) of Company P's interest in the surplus of Company S on December 31, 1934, can therefore be made as in the second illustration. (See page 337.)

Working papers for fourth illustration.

COMPANY P AND SUBSIDIARY S

Consolidated Working Papers

Year Ended December 31, 1934

	Company		ADJUSTMENTS AND ELIMINATIONS		Mi- nority	Conso- dated
	P	S	Debit	Credit		
(Cost of Goods Sold Section—same as in first illustration.)						
PROFIT AND LOSS						
Sales.....	125,000.00	100,000.00	25,000.00(A)	25,000.00		200,000.00
Less Cost of Goods Sold (Brought forward).....	98,000.00	79,000.00				152,000.00
Gross Profit on Sales.....	27,000.00	21,000.00				48,000.00
Less Expenses.....	15,000.00	11,000.00				26,000.00
Net Profit.....	12,000.00	10,000.00				22,000.00
Dividend from Company S.....	2,700.00		2,700.00(C)			
Company S Profit—90%.....			9,000.00(D)	9,000.00(C)		
Net Profit before Deduction of Minority Interest.....	14,700.00	10,000.00			1,000.00	22,000.00
Minority Interest—10%.....					1,000.00	1,000.00
Net Income (Forward).....	14,700.00	10,000.00	36,700.00	34,000.00		21,000.00
SURPLUS						
Surplus, December 31, 1933:						
Company P.....	34,500.00			4,500.00(C)		39,000.00
Company S.....		15,000.00	13,500.00(D)		1,500.00	1,500.00
Net Income (Brought forward).....	14,700.00	10,000.00	36,700.00	34,000.00	1,000.00	21,000.00
Total.....	49,200.00	25,000.00			2,500.00	60,000.00
Less Dividends Paid:						
Company P.....	6,000.00					6,000.00
Company S.....		3,000.00		2,700.00(D)	300.00	300.00
Surplus, December 31, 1934 (Forward).....	43,200.00	22,000.00	50,200.00	41,200.00	2,200.00	54,000.00

ASSETS

Cash.....	31,700.00	26,000.00	57,700.00
Accounts Receivable.....	50,000.00	40,000.00	90,000.00
Inventory.....	27,000.00	16,000.00	43,000.00
Investment in Stock of Company S—90%—At Cost	57,000.00		
Add 90% of Increase in Company S Surplus.....		10,800.00(C)	
Eliminate:			
Capital Stock.....			
Surplus.....		45,000.00(B)	
Goodwill.....		19,800.00(D)	
	<u>165,700.00</u>	<u>82,000.00</u>	<u>3,000.00</u>
			<u><u>193,700.00</u></u>

LIABILITIES AND NET WORTH

Accounts Payable.....	22,500.00	10,000.00	32,500.00
Capital Stock:			
Company P.....	100,000.00		100,000.00
Company S.....	50,000.00	45,000.00(B)	5,000.00
Surplus (Brought forward).....	43,200.00	50,200.00	2,200.00
Total Minority Interest.....		41,200.00	7,200.00
	<u>165,700.00</u>	<u>82,000.00</u>	<u>106,000.00</u>
			<u><u>193,700.00</u></u>

Summary and Comparison of the Four Illustrations

The adjustments and eliminations in the four preceding illustrations are compared below:

	SUBSIDIARY PROFITS, LOSSES, AND DIVIDENDS TAKEN UP			
	Illustration 1 (No dividends)	Illustration 2 (Dividends)	Illustration 3 (No dividends)	Illustration 4 (Dividends)
	Illustration 1 (No dividends)	Illustration 2 (Dividends)	Illustration 3 (No dividends)	Illustration 4 (Dividends)
(A) Intercompany Sales:				
Sales.....	25,000	25,000	25,000	25,000
Purchases.....	25,000	25,000	25,000	25,000
(B) Par of Stock Owned:				
Capital Stock—Co. S.....	45,000	45,000	45,000	45,000
(C) Increase in Subsidiary Surplus since Acquisition:				
Investment in Co. S.....	45,000	45,000	45,000	45,000
Investment in Co. S.....			13,500	10,800
Dividend from Co. S.....			4,500	2,700
Surplus—Co. P.....			9,000	9,000
Company S Profit.....				4,500
(D) Elimination of Subsidiary Surplus at End of Year:				
Surplus—Co. S.....	13,500	13,500	13,500	13,500
Company S Profit.....	9,000	9,000	9,000	9,000
Dividends Paid.....		2,700		2,700
Investment in Co. S.....	22,500		22,500	19,800

Working Papers from Trial Balances

In all of the foregoing illustrations, it was assumed that the accountant was furnished with statements of the several companies, which he copied into the Company columns of the working papers. If trial balances are furnished instead of statements, the working papers may be prepared in the manner illustrated, but the accountant will be obliged to construct the individual company statements in the working papers.

Company Adjustments

In the four preceding illustrations, the statements of the individual companies were assumed to be correct, and the only adjustments required were those necessitated by the inter-company relationships. But the company statements may themselves require adjustments for the correction of omissions or other errors.

To illustrate, let us refer to the working papers for the first illustration, on page 334, and assume that adjustments are required for accrued wages in the amount of \$1,000.00 for Company *P* and \$2,000.00 for Company *S*. Two methods are available for dealing with such adjustments.

First method of dealing with company adjustments.—In the working papers on pages 348 and 349, the unadjusted statements of the two companies were entered in the Company columns, and adjustments and eliminations were made thus:

- (1) Accrued wages (Company *P*, \$1,000.00; Company *S*, \$2,000.00) were debited to Expenses and credited to Accrued Wages in total.
- (2) Company *P* took up 90% of the incorrect profits (\$10,000.00) of the subsidiary; the adjustment for accrued wages decreases the profits of the subsidiary \$2,000.00; the parent company's accounts are adjusted for 90% of this amount (\$1,800.00) by an entry debiting Company *S* Profit and crediting Investment in Stock of Company *S*.

The remaining adjustments are the same as in the first illustration, except that they are modified by the reduction in the subsidiary profit; these adjustments are:

- (A) Elimination of intercompany sales and purchases.

COMPANY P AND SUBSIDIARY S
Consolidated Working Papers
Year Ended December 31, 1934

(Cost of Goods Sold Section—same as in first illustration.)	Company		ADJUSTMENTS AND ELIMINATIONS		Mi- nority	Conso- li- dated
	P	S	Debit	Credit		
PROFIT AND LOSS						
Sales.....	125,000.00	100,000.00				200,000.00
Less Cost of Sales (Brought forward).....	98,000.00	79,000.00	25,000.00(A)	25,000.00		152,000.00
Gross Profit on Sales.....	27,000.00	21,000.00				48,000.00
Less Expenses.....	15,000.00	11,000.00	3,000.00(1)			29,000.00
Net Profit.....	12,000.00	10,000.00				19,000.00
Company S Profit—90%.....	9,000.00		}	1,800.00(2)		
			}	7,200.00(D)		
Total.....	21,000.00	10,000.00			800.00	19,000.00
Minority Interest—10% of Adjusted Profit (See Note)					800.00	
Net Income (Forward).....	21,000.00	10,000.00	37,000.00	25,000.00	800.00	18,200.00

Note

Net Income per Books.....	10,000.00
Accrued Wages.....	2,000.00
Adjusted Net Income.....	8,000.00
Minority Interest—10%.....	800.00
SURPLUS	
Surplus—December 31, 1933:	
Company P.....	39,000.00
Company S.....	15,000.00
Net Income (Brought forward).....	13,500.00(D)
Surplus—December 31, 1934.....	37,000.00
	25,000.00
	50,500.00
	1,500.00
	800.00
	2,300.00
	18,200.00
	57,200.00

Assets

Cash.....	35,000.00	29,000.00	64,000.00
Accounts Receivable.....	50,000.00	40,000.00	90,000.00
Inventory.....	27,000.00	16,000.00	43,000.00
Investment in Stock of Company S—90%.....	70,500.00		
Eliminate:			
Capital Stock.....			
Surplus.....			
Goodwill.....			
	<u>182,500.00</u>	<u>85,000.00</u>	<u>3,000.00</u>
			<u>200,000.00</u>

LIABILITIES AND NET WORTH

Accounts Payable.....	22,500.00	10,000.00	32,500.00
Accrued Wages.....			3,000.00
Capital Stock:			
Company P.....	100,000.00		100,000.00
Company S.....	50,000.00	45,000.00(B)	5,000.00
Surplus (Brought forward).....	60,000.00	25,000.00	2,300.00
Total Minority Interest.....	<u>182,500.00</u>	<u>85,000.00</u>	<u>7,300.00</u>
			<u>200,000.00</u>

1,800.00(2)

45,000.00(B)

20,700.00(D)

3,000.00(1)

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- (B) Elimination of par value of stock held by parent company.
- (C) Not required because investment is not carried at cost.
- (D) Elimination of parent company's percentage of subsidiary surplus.

Numbers are used for the first two adjustments in the preceding working papers merely to emphasize the new features of this illustration.

Special attention is directed to one point in the working papers: In the Profit and Loss section of the papers, the 10% minority interest is computed, not on the \$10,000.00 net profit of the subsidiary as shown by the Company *S* column, but on the adjusted net profit as shown in the note immediately following the Profit and Loss section.

Second method of dealing with company adjustments.—In the working papers on page 351, (based on the same facts as those in the working papers on pages 348 and 349), the company statements were adjusted before they were entered. Adjustments 1 and 2 do not appear in the papers because effect has been given to them in the company statements. Thus, (1) the expenses and the liabilities have been increased by the amounts of the accrued expenses, totaling \$3,000.00; and (2) the Company *S* Profit account and the Investment account have been reduced by 90% of the \$2,000.00 decrease in the net profit of the subsidiary. Eliminations A, B, and D are the same as in the preceding illustration.

By this method the working papers show correct statements for each company as well as correct consolidated statements.

Stock Purchases During the Period

A slight complication arises if the stock of a subsidiary was purchased during the period for which the consolidated statements are being prepared. To illustrate, assume that Company *S* had capital stock of \$100,000.00 and surplus of \$50,000.00 on January 1, 1933. Company *P* purchased 90% of the stock on April 1, 1933, for \$140,000.00. Company *S* made a profit of \$20,000.00 during 1933, in equal quarterly

COMPANY P AND SUBSIDIARY S
Consolidated Working Papers—Year Ended December 31, 1934

	Company		ADJUSTMENTS AND ELIMINATIONS		Mi- nority	Consol- dated
	P	S	Debit	Credit		
(Cost of Goods Sold Section—same as in first illustration.)						
PROFIT AND LOSS						
Sales	125,000 00	100,000.00	25,000.00(A)	25,000.00		200,000.00
Less Cost of Sales (Brought forward)	98,000 00	79,000 00				152,000.00
Gross Profit on Sales	27,000 00	21,000 00				48,000.00
Less Expenses	16,000 00	13,000 00				29,000.00
Net Profit	11,000 00	8,000 00				19,000.00
Company S Profit—90 %	7,200 00		7,200.00(D)			
Total	18,200.00	8,000.00			800.00	19,000.00
Minority interest—10 % of \$8,000.00					800 00	800.00
Net Income (Forward)	18,200.00	8,000 00	32,200.00	25,000.00		18,200.00
SURPLUS						
Surplus—December 31, 1933:						
Company P	39,000.00					39,000.00
Company S	18,200.00	15,000.00	13,500.00(D)		1,500 00	800.00
Net Income (Brought forward)	57,200.00	8,000.00	32,200.00	25,000.00	800 00	18,200.00
Surplus—December 31, 1934	18,200.00	23,000.00	45,700.00	25,000.00	2,300.00	57,200.00
ASSETS						
Cash	35,000.00	29,000 00				64,000.00
Accounts Receivable	50,000.00	40,000.00				90,000.00
Inventory	27,000 00	16,000.00				43,000.00
Investment in Stock of Co. S—90 %	68,700.00					
Eliminate:						
Capital Stock				45,000.00(B)		
Surplus				20,700.00(D)		
Goodwill						
	180,700.00	85,000.00				3,000.00
LIABILITIES AND NET WORTH						
Accounts Payable	22,500 00	10,000 00				32,500.00
Accrued Wages	1,000 00	2,000 00				3,000.00
Capital Stock						
Company S	100,000.00					100,000.00
Company P	57,200.00	50,000 00	45,000.00(B)		5,000 00	57,200.00
Surplus (Brought forward)	57,200.00	23,000.00	45,700.00	25,000.00	2,300 00	7,300.00
Total Minority Interest	180,700.00	85,000 00	90,700.00	90,700.00		200,000.00

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amounts of \$5,000.00. Company *P* took up its 90% of the \$15,000.00 profit earned during the three quarters of the year subsequent to acquisition.

The profits of the subsidiary for 1933 accruing to the parent company and properly included in the consolidated net income for the year were:

Total profit of Company <i>S</i>			\$20,000
Deduct: Minority interest—10% of \$20,000.00.....		\$2,000	
Profit applicable to the 90% interest of Company <i>P</i> ,			
but earned prior to acquisition—90% of \$5,000.00	4,500	6,500	
Remainder—or 90% of the \$15,000.00 earned after Apr. 1, 1933.....			<u>\$13,500</u>

The student should note, in the working papers on page 353, the method of deducting these two items (\$2,000.00 and \$4,500.00) to determine the consolidated net income.

Elimination D in the working papers on page 353 is similar in nature to the D eliminations in the preceding illustrations, except for the additional item of \$4,500.00. The entire elimination entry is:

	<u>Section</u>	<u>Debit</u>	<u>Credit</u>
Subsidiary profit earned during last 9 months of 1933, taken up by parent company—90% of \$15,000.00.....	P. & L.	\$13,500.00	
Subsidiary profit earned in 1933 on parent company's portion of stock, prior to acquisition—90% of \$5,000.00 profit for first ¼ of year.....	P. & L.	4,500.00	
Subsidiary surplus on December 31, 1932—90% of \$50,000.00.....	Surplus	45,000.00	
Total eliminated from Investment account—90% of subsidiary surplus on December 31, 1933.....	Assets		\$63,000.00

Dividends paid by the parent company decrease the consolidated surplus, and should be extended to the Consolidated column of the working papers. Dividends paid by the subsidiary do not affect the consolidated surplus; therefore the total dividends paid by the subsidiary should be entered in the Elimination and Minority columns, so that nothing will remain to be extended to the Consolidated column.

To illustrate, assume that the parent company, in addition to acquiring 90% of the subsidiary stock on April 1, also purchased 5% of the stock on October 1. Assume also that

COMPANY P AND SUBSIDIARY S
Consolidated Working Papers—Year Ended December 31, 1933
(Cost of Goods Sold Section Omitted)

	Com- pany P	Com- pany S	ADJUSTMENTS AND ELIMINATIONS		Mi- nority	Consoli- dated
			Debit	Credit		
PROFIT AND LOS						
Sales.....	500,000	300,000				775,000
Less Cost of Goods Sold (Brought forward).....	400,000	200,000	25,000(A)	25,000		575,000
Gross Profit on Sales.....	100,000	100,000				200,000
Less Expenses.....	75,000	80,000				155,000
Net Profit.....	25,000	20,000				45,000
Company S Profit—90% for ¾ of a year.....	13,500		13,500(D)			45,000
Net Profit Before Deduction of Minority Interest and Profits Earned Prior to Acquisition.....	38,500	20,000				2,000
Deductions:						
Minority Interest—10% of \$20,000.....					2,000	
Subsidiary Profits Applicable to Stock Owned by Parent Company, but Earned Prior to Date of Acquisition—90% of ¼ of \$20,000.....			4,500(D)			4,500
Total Deductions.....	38,500	20,000	43,000	25,000	2,000	6,500
Net Income (Forward).....					2,000	38,500
SURPLUS						
Surplus, December 31, 1932: *						
Company P.....	100,000					100,000
Company S.....	38,500	50,000			5,000	2,000
Net Income (Brought forward).....	138,500	70,000	45,000(D)	25,000	2,000	38,500
Surplus, December 31, 1933.....	138,500	70,000	88,000	25,000	7,000	138,500
ASSETS						
Sundry Assets.....	295,000	210,000				505,000
Investment in Stock of Company S—80%.....	153,500					
Eliminate:						
Capital Stock.....	448,500	210,000		90,000(B)		500
Surplus.....	153,500			63,000(D)		505,500
Goodwill.....						
LIABILITIES AND NET WORTH						
Sundry Liabilities.....	60,000	40,000				100,000
Capital Stock:						
Company P.....	250,000					250,000
Company S.....	138,500	70,000		90,000(B)	10,000	138,500
Surplus (Brought forward).....	138,500	70,000	88,000	25,000	7,000	17,000
Total Minority Interest.....	448,500	210,000	178,000	178,000	17,000	505,500

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the subsidiary paid a \$5,000.00 dividend on July 1; this dividend reduced the subsidiary surplus at the end of the year from \$70,000.00 to \$65,000.00. The elimination D in the working papers on page 353 would be:

	<u>Section</u>	<u>Debit</u>	<u>Credit</u>
Subsidiary profit earned:			
Last 9 months—90% of $\frac{3}{4}$ of \$20,000.00	\$13,500		
Last 3 months—5% of $\frac{1}{4}$ of \$20,000.00	<u>250</u>	P. & L.	\$13,750
Subsidiary profit prior to acquisition:			
95% of \$20,000.00.....	\$19,000		
Less.....	<u>13,750</u>	P. & L.	5,250
Subsidiary surplus—December 31, 1932—			
95% of \$50,000.00.....		Surplus	47,500
Dividend of subsidiary—95% of \$5,000.00		Surplus	\$ 4,750
Net elimination from Investment account			
—95% of \$65,000.00 subsidiary surplus		Assets	61,750

CHAPTER 50

CONSOLIDATED BALANCE SHEET, SURPLUS STATEMENT, PROFIT AND LOSS STATEMENT, AND SUPPORTING STATEMENTS (Concluded)

Outline of illustrations.—This chapter, like the preceding one, contains four principal illustrations requiring consolidated statements for the year 1934. The illustrations in this chapter are somewhat more complex than those in the preceding chapter, because:

There are two subsidiaries. Company *A*, the parent company, owns:

90% of the stock of Company *B*, which it acquired on January 1, 1930; the surplus of Company *B* on that date was \$15,000.00.

80% of the stock of Company *C*, which it acquired on January 1, 1934; the surplus of Company *C* on that date was \$20,000.00.

Numerous additional adjustments and eliminations of intercompany operating transactions are illustrated.

As in the preceding chapter, the four illustrations differ as follows:

First and second illustrations: The parent company has taken up its share of subsidiary profits, losses, and dividends through the Investment accounts:

First illustration: No dividends were paid during 1934.

Second illustration: Dividends were paid during 1934.

Third and fourth illustrations: The parent company is carrying the investments at cost:

Third illustration: No dividends were paid during 1934.

Fourth illustration: Dividends were paid during 1934.

First and second illustrations.—In the first two illustrations it is assumed that the parent company has taken up its share of subsidiary profits, losses, and dividends through

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the Investment accounts. The two illustrations differ only in the matter of dividends during 1934, the year for which the statements are being prepared.

First illustration.—The working papers for this illustration appear on pages 360 and 361. Following is an explanation of the eliminations and adjustments appearing therein: Entries A to F will be the same in all four illustrations; entries G to L will vary.

Elimination A: Intercompany sales.—Companies A and B manufacture; Company A sells to outsiders only; Company B sells to Company A and to outsiders. Company C does not manufacture, but deals only in raw materials, selling to outsiders and to Companies A and B. The intercompany sales during 1934 were as follows:

<u>By</u>	<u>To</u>	<u>Amount</u>
Company C.....	Company B.....	\$ 60,000.00
Company C.....	Company A.....	35,000.00
Company B.....	Company A.....	75,000.00
Total.....		<u>\$170,000.00</u>

These intercompany transactions were recorded in the regular Sales and Purchases accounts, and must be eliminated. Note elimination A in the cost of goods sold papers, crediting Purchases \$170,000.00, and the offsetting elimination in the profit and loss papers, debiting Sales.

Elimination B: Intercompany receivables and payables.—The following intercompany balances are included in the accounts receivable and accounts payable in the balance sheet papers:

Owed to Company B:	
By Company A.....	\$ 5,000.00
Owed to Company C:	
By Company A.....	2,900.00
By Company B.....	3,600.00
Total.....	<u>\$11,500.00</u>

The \$11,500.00 total of intercompany balances is eliminated from the accounts receivable and accounts payable in the balance sheet papers.

Adjustment C: Intercompany profit in opening inventories.—The inventories on December 31, 1933 (the end of the preceding year) contained profits made on intercompany sales, as follows:

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	<u>PROFIT MADE BY</u>	
	<u>Company B</u>	<u>Company C</u>
On goods in Company A's inventory:		
Raw materials	\$2,000.00	\$1,000.00
Goods in process	1,500.00	800 00
On goods in Company B's inventory:		
Raw materials		500.00
Goods in process		800.00
Finished goods		250.00

Company A owned 90% of the stock of Company B on December 31, 1933; when it prepared its consolidated statements as of that date, it eliminated 90%, or \$3,150.00, of the \$3,500.00 profit made by Company B because this \$3,150.00 was an intercompany profit not to be included in the consolidated net income until the goods were sold to outsiders. This intercompany profit is detailed as follows:

On raw materials—90% of \$2,000.00	\$1,800.00
On goods in process—90% of \$1,500.00	1,350.00
Total	<u>\$3,150.00</u>

The adjustment for this intercompany profit, made in the working papers as of December 31, 1933, reduced by \$3,150.00 the inventory valuation and the consolidated surplus as of that date. To be consistent, the same adjustment must be made in the December 31, 1934 working papers, reducing the opening inventory and the opening surplus by \$3,150.00; therefore, note:

In the surplus papers: The \$3,150.00 debit to Company A's Surplus as of the beginning of 1934.

In the cost of goods sold papers: The offsetting credits reducing the opening inventories—a credit of \$1,800.00 to the raw materials inventory, and a credit of \$1,350.00 to the goods in process inventory.

Company A did not buy the stock of Company C until January 1, 1934; the profit made by Company C on sales of goods to Companies A and B prior to that date was not intercompany profit, because no intercompany relationship existed when the sales were made. The profit in the December 31, 1933 inventories of goods acquired from Company C may therefore be ignored.

Adjustment D: Intercompany profit in closing inventories.—The inventories on December 31, 1934 contained intercompany profits as follows:

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	PROFIT MADE BY	
	Company <i>B</i>	Company <i>C</i>
On goods in Company <i>A</i> 's inventory:		
Raw materials	\$2,500.00	\$1,200.00
Goods in process	800.00	200.00
Finished goods	1,800.00	1,500.00
On goods in Company <i>B</i> 's inventory:		
Raw materials		500.00
Goods in process		1,000.00
Finished goods		1,300.00
Total	\$5,100.00	\$5,700.00
Per cent of subsidiary stock owned by Co. <i>A</i> . .	90%	80%
Deductions to be made for intercompany profit	<u>\$4,590.00</u>	<u>\$4,560.00</u>

The total deduction is thus found to be \$9,150.00, but separate deductions must be made from raw materials, goods in process, and finished goods. The amounts of these deductions are determined as follows:

	In Inventory of	Sold By	Per Cent of Selling Com- pany's Stock Owned by		Deduction
			Company <i>A</i>	Company <i>A</i> Profit	
Raw Materials:	Company <i>A</i>	Company <i>B</i>	90%	\$2,500	\$2,250
	Company <i>A</i>	Company <i>C</i>	80%	1,200	960
	Company <i>B</i>	Company <i>C</i>	80%	500	400
	Total				<u>\$3,610</u>
Goods in Process:	Company <i>A</i>	Company <i>B</i>	90%	800	\$ 720
	Company <i>A</i>	Company <i>C</i>	80%	200	160
	Company <i>B</i>	Company <i>C</i>	80%	1,000	800
	Total				<u>\$1,680</u>
Finished Goods:	Company <i>A</i>	Company <i>B</i>	90%	1,800	\$1,620
	Company <i>A</i>	Company <i>C</i>	80%	1,500	1,200
	Company <i>B</i>	Company <i>C</i>	80%	1,300	1,040
	Total				<u>\$3,860</u>
Total					<u>\$9,150</u>

The adjustments for the above amounts of intercompany profits are made in the working papers as follows:

In the cost of goods sold papers: By debits against the December 31, 1934 inventories, which appear in this section as credits.

In the balance sheet papers: By credits against the inventories, which appear in this section as debits.

Elimination E: Intercompany rent.—Company *A* leases certain equipment to Company *B* at an annual rent of \$3,000.00.

The amount of this intercompany rent is eliminated as follows:

In the cost of goods sold papers: The \$3,000.00 (which is included in the manufacturing expenses of Company B) is eliminated by a credit.

In the profit and loss papers: The \$3,000.00 (shown as miscellaneous income in the profit and loss statement of Company A) is eliminated by a debit.

Elimination F: Bond interest.—Company C has an issue of \$50,000.00 of 5% bonds, of which Company A owns \$40,000.00. The collection of \$2,000.00 of bond interest by Company A is an intercompany transaction, which is eliminated in the profit and loss papers as follows:

From Company A's miscellaneous income by a debit.

From Company C's bond interest expense by a credit.

Elimination G: Company A's interest in stock of Company B.—Company B has \$100,000.00 of capital stock, of which Company A owns 90%, or \$90,000.00. This intercompany stockholding is eliminated in the balance sheet papers as follows:

From Company A's Investment account by a credit.

From Company B's Capital Stock account by a debit.

Adjustment H: Increase in surplus of Company B since acquisition.—This adjustment (like the C adjustments in the preceding chapter) is not required in the first and second illustrations, because the parent company has already taken up its share of the subsidiary's income since acquisition. The adjustment is required in the third and fourth illustrations, in which the investments are carried at cost.

Elimination I: Company A's interest in surplus of Company B.—The parent company's interest in the subsidiary's surplus at the date of the balance sheet is eliminated from the Investment account by a credit, in the customary manner. If only a consolidated balance sheet were to be prepared, the offsetting debit elimination would be made from the subsidiary surplus in the balance sheet papers. But since consolidated surplus and consolidated profit and loss statements are to be prepared, the debit must be apportioned between the surplus at the beginning of the period (in the surplus papers) and the changes during the period (in the profit and loss papers).

These elements of Company B's surplus, and of Company A's 90% interest therein, are detailed on page 362.

Working papers for first illustration.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Working Papers
Year Ended December 31, 1934

	Com- pany A	Com- pany B	Com- pany C	ADJUSTMENTS AND ELIMINATIONS	Minority Interests	Consoli- dated
				Debit	Credit	
Cost of Goods Sold						
Materials:						
Inventory, December 31, 1933.....	40,000	15,000	15,000			68,200
Purchases.....	145,000	95,000	76,000		1,800(C)	146,000
Total.....	185,000	110,000	91,000		170,000(A)	214,200
Less Inventory, December 31, 1934.....	50,000	25,000	11,000	3,610(D)		82,390
Materials Used.....	135,000	85,000	80,000			131,810
Direct Labor.....	85,000	65,000	80,000		3,000(E)	150,000
Manufacturing Expense.....	40,000	70,000	80,000		1,350(C)	107,000
Total.....	290,000	190,000	80,000			388,810
Add Goods in Process, December 31, 1933.....	25,000	30,000	80,000			53,650
Total.....	315,000	220,000	80,000			442,460
Deduct Goods in Process, December 31, 1934.....	55,000	25,000	80,000	1,680(D)		78,320
Cost of Goods Manufactured.....	260,000	195,000	80,000			364,140
Add Inventory of Finished Goods, December 31, 1933.....	260,000	225,000	80,000			394,140
Total.....	45,000	50,000	80,000	3,860(D)		91,140
Deduct Inventory of Finished Goods, December 31, 1934.....	215,000	175,000	80,000	9,150	176,150	303,000
Cost of Goods Sold (Forward).....	300,000	225,000	120,000	170,000(A)		475,000
Gross Sales.....	3,000	2,000	1,000			6,000
Less Returned Sales and Allowances.....	297,000	223,000	119,000			469,000
Net Sales.....	215,000	175,000	80,000	9,150	176,150	303,000
Less Cost of Goods Sold (Brought forward).....	82,000	48,000	39,000			166,000
Gross Profit on Sales.....	23,000	22,000	15,000			60,000
Less Selling Expenses.....	59,000	26,000	24,000			109,000
Net Profit on Sales.....	35,000	17,000	21,000			36,000
Less General Expenses.....	15,300(I)	14,800(J)	14,800(K)			30,000(L)
Net Profit on Operations.....	3,000(M)	3,000(N)	2,000(O)			6,000(P)
Add Miscellaneous Income:						
Company B Profit—90 %.....	70,100	17,000	21,000			70,000
Company C Profit—80 %.....	64,100	17,000	18,500		2,000(F)	6,500
Rent of Equipment to Company B.....						
Bond Interest from Company C.....						
Net Profit on Operations and Other Income.....						
Less Bond Interest Paid.....						
Net Income before Deduction of Minority Interests.....						
Net Income before Deduction of Minority Interests.....						

362 BALANCE SHEET, SURPLUS, PROFIT AND LOSS

	COMPANY B SURPLUS	
	Total	Company A's 90%
Surplus, December 31, 1933.....	\$25,000.00	\$22,500.00
Net Profit, 1934.....	17,000.00	15,300.00
Surplus, December 31, 1934.....	\$42,000.00	\$37,800.00

The elimination of Company A's 90% interest is made as follows:

	Section	Debit	Credit
Surplus of Co. B—as of December 31, 1933	Surplus	\$22,500	
Co. B Profit (taken up by Co. A).....	P. & L.	15,300	
Investment in Company B.....	Assets		\$37,800

Elimination J: Company A's interest in stock of Company C.—
Company C has \$50,000.00 of capital stock, of which Company A owns 80%, or \$40,000.00. This intercompany stockholding is eliminated in the balance sheet papers as follows:

From Company A's Investment account by a credit.
From Company C's Capital Stock account by a debit.

Adjustment K: Increase in surplus of Company C since acquisition.

This adjustment is not required in the first and second illustrations, because the parent company has taken up its share of the subsidiary's income since acquisition. It is required in the third and fourth illustrations, in which the investments are carried at cost.

Elimination L: Company A's interest in surplus of Company C.—
The amount of the credit elimination from Company A's Investment in Company C, as representing Company A's 80% interest in the surplus of Company C, and the amounts of the offsetting debits to Surplus and current profits, are determined as follows:

	COMPANY C SURPLUS	
	Total	Company A's 80%
Surplus, January 1, 1934.....	\$20,000.00	\$16,000.00
Net Profit, 1934.....	18,500.00	14,800.00
Surplus, December 31, 1934.....	\$38,500.00	\$30,800.00

The elimination is made as follows:

	Section	Debit	Credit
Surplus of Co. C—as of December 31, 1933	Surplus	\$16,000	
Co. C Profit (taken up by Co. A).....	P. & L.	14,800	
Investment in Company C.....	Assets		\$30,800

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 363

Consolidated statements: First illustration.—Following are the consolidated statements prepared from the foregoing working papers:

COMPANY A AND SUBSIDIARIES B AND C Exhibit D
Consolidated Statement of Cost of Goods Sold
For the Year Ended December 31, 1934

Materials:	
Inventory, December 31, 1933.	\$ 68,200.00
Purchases.	146,000.00
Total.	<u>\$214,200.00</u>
Less Inventory, December 31, 1934.	82,390.00
Cost of Materials Used or Sold.	<u>\$131,810.00</u>
Direct Labor.	150,000.00
Manufacturing Expense.	107,000.00
Total.	<u>\$388,810.00</u>
Add Goods in Process, December 31, 1933.	53,650.00
Total.	<u>\$442,460.00</u>
Deduct Goods in Process, December 31, 1934.	78,320.00
Cost of Goods Manufactured, and Materials Sold.	<u>\$364,140.00</u>
Add Finished Goods, December 31, 1933.	30,000.00
Total.	<u>\$394,140.00</u>
Deduct Finished Goods, December 31, 1934.	91,140.00
Cost of Goods Sold.	<u>\$303,000.00</u>

COMPANY A AND SUBSIDIARIES B AND C Exhibit C
Consolidated Profit and Loss Statement
For the Year Ended December 31, 1934

Gross Sales.	\$475,000.00
Less Returned Sales and Allowances.	6,000.00
Net Sales.	<u>\$469,000.00</u>
Less Cost of Goods Sold (Exhibit D).	303,000.00
Gross Profit on Sales.	<u>\$166,000.00</u>
Less Selling Expenses.	60,000.00
Net Profit on Sales.	<u>\$106,000.00</u>
Less General Expenses.	36,000.00
Net Profit on Operations.	<u>\$ 70,000.00</u>
Less Bond Interest Paid.	6,500.00
Net Income.	<u>\$ 63,500.00</u>
Less Minority Interests in Net Income.	5,400.00
Parent Company's Portion of Consolidated Net Income.	<u>\$ 58,100.00</u>

COMPANY A AND SUBSIDIARIES B AND C Exhibit F
Consolidated Surplus Statement
For the Year Ended December 31, 1934

Surplus, December 31, 1933.	\$31,850.00
Net Income for 1934.	<u>58,100.00</u>
Surplus, December 31, 1934.	<u>\$89,950.00</u>

364 BALANCE SHEET, SURPLUS, PROFIT AND LOSS

COMPANY A AND SUBSIDIARIES B AND C Exhibit A

Consolidated Balance Sheet

December 31, 1934

Assets	
Current Assets:	
Cash.....	\$ 72,500.00
Accounts Receivable.....	84,200.00
Inventories:	
Raw Materials..	\$82,390 00
Goods in Process.	78,320.00
Finished Goods.	91,140 00
Total Current Assets.....	<u>251,850 00</u>
Fixed Assets:	
Land.....	\$ 95,000.00
Buildings—Less Depreciation.....	235,000 00
Machinery—Less Depreciation.....	<u>145,000 00</u>
Total Fixed Assets.....	475,000.00
Goodwill.....	15,000 00
	<u>\$898,550.00</u>
Liabilities and Net Worth	
Current Liabilities:	
Accounts Payable.....	\$166,700.00
Fixed Liabilities:	
Bonds Payable—6%.....	\$100,000.00
Bonds Payable—5%.....	\$50,000.00
Less Bonds in Treasury.	<u>40,000.00</u>
Total Fixed Liabilities.....	<u>10,000.00</u>
Minority Interests.....	110,000.00
Minority Interests.....	31,900.00
Net Worth:	
Capital Stock.....	\$500,000.00
Surplus (Exhibit B).....	<u>89,950.00</u>
Total Net Worth.....	<u>589,950.00</u>
	<u>\$898,550.00</u>

Second illustration. (See working papers, pages 366 and 367.)—This illustration is the same as the preceding one, with one exception: Dividends were paid by all companies during the year 1934. The dividend payments by the subsidiaries reduced their surplus balances at the end of the year; consequently, eliminations I and L, eliminating the parent company's interests in the surpluses of the subsidiaries, differ from the corresponding eliminations in the preceding illustration.

Elimination I: Company A's interest in surplus of Company B.—The elements of Company B's surplus at the end of 1934, and Company A's 90% interest therein, are detailed in the following summary:

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 365

	COMPANY B SURPLUS	
	Total	Company A's 90%
Surplus, December 31, 1933.....	\$25,000.00	\$22,500.00
Add Net Profit, 1934.....	17,000.00	15,300.00
Deduct Dividends Paid, 1934.....	6,000.00*	5,400.00*
Surplus, December 31, 1934.....	\$36,000.00	\$32,400.00

* Deductions.

The elimination of Company A's 90% interest is made by the following entry:

	Section	Debit	Credit
Surplus of Co. B—as of December 31, 1933	Surplus	\$22,500	
Company B Profit (taken up by Company A)	P. & L.	15,300	
Dividends Paid.....	Surplus		\$ 5,400
Investment in Company B.....	Assets		32,400

The student should trace these entries to the working papers on page 366 and should compare them with elimination I in the first illustration, on page 360.

Elimination L: Company A's interest in surplus of Company C.—

The amount of the credit elimination from Company A's Investment in Company C, as representing Company A's 80% interest in the surplus of Company C, and the amounts of the offsetting entries, are determined as follows:

	COMPANY C SURPLUS	
	Total	Company A's 80%
Surplus, January 1, 1934.....	\$20,000.00	\$16,000.00
Add Net Profit, 1934.....	18,500.00	14,800.00
Deduct Dividends Paid, 1934.....	3,000.00*	2,400.00*
Surplus, December 31, 1934.....	\$35,500.00	\$28,400.00

* Deductions.

The elimination of Company A's 80% interest is made by the following entry:

	Section	Debit	Credit
Surplus of Co. C—as of December 31, 1933	Surplus	\$16,000	
Company C Profit (taken up by Company A)	P. & L.	14,800	
Dividends Paid.....	Surplus		\$ 2,400
Investment in Company C.....	Assets		28,400

The similar adjustment for the first illustration appears on page 362.

Working papers for second illustration.

COMPANY A AND SUBSIDIARIES B AND C

Consolidated Working Papers
Year Ended December 31, 1934

	Com- pany A	Com- pany B	Com- pany C	ADJUSTMENTS AND ELIMINATIONS		Minority Interests	Consoli- dated
				Debit	Credit		
(Cost of Goods Sold Section—Same as in first illustration.) (Profit and Loss Section—Same as in first illustration.)							
SURPLUS							
Surplus, December 31, 1933:							
Company A.....	35,000						
Intercompany Profit in Inventories, Dec. 31, 1933				3,150 (C)			31,850
Adjusted Balance.....		25,000		22,500 (I)		2,500	
Company B.....			20,000	16,000 (L)		4,000	
Company C.....	64,100	17,000	18,500	214,250	178,150	5,400	58,100
Net Income (Brought forward).....	99,100	42,000	38,500			11,900	89,950
Total.....							
Less Dividends Paid:							
Company A.....	30,000					600*	30,000
Company B.....		6,000				600*	
Company C.....			3,000				
Surplus, December 31, 1934 (Forward).....	69,100	36,000	35,500	255,900	185,950	10,700	59,950
ASSETS							
Cash.....	17,800	10,000	13,500				41,300
Accounts Receivable.....	53,700	17,000	25,000			11,500 (B)	84,200
Inventories:							
Raw Materials.....	50,000	25,000	11,000			3,610 (D)	82,390
Goods in Process.....	55,000	25,000				1,680 (D)	78,320
Finished Goods.....	45,000	50,000				3,860 (D)	91,140
Land.....	50,000	20,000	25,000				95,000
Buildings—Less Depreciation.....	140,000	35,000	60,000				235,000

Equipment—Less Depreciation.....	90,000	40,000	15,000	145,000
Investment in Stock of Company B—90%.....	127,400			
Eliminate:				
Capital Stock.....				90,000(G)
Surplus.....				32,400(I)
Goodwill.....				
Investment in Stock of Company C—80%.....	78,400			5,000G
Eliminate:				
Capital Stock.....				40,000(J)
Surplus.....				28,400(L)
Goodwill.....				
Investment in Bonds of Company C.....	40,000			10,000G
	<u>747,300</u>	<u>222,000</u>	<u>149,500</u>	<u>40,000</u>
				<u>907,350</u>
				166,700
				100,000
				50,000
				500,000
				10,000
				10,000
				10,700
				59,950
				30,700
				<u>907,350</u>
LIABILITIES AND NET WORTH				
Accounts Payable.....				
Bonds Payable:				
Company A.....	100,000			
Company B.....		100,000		
Company C.....			50,000	
Surplus (Brought forward).....	69,100	36,000	35,500	185,950
Total Minority Interest.....				30,700
	<u>747,300</u>	<u>222,000</u>	<u>149,500</u>	<u>397,400</u>
				<u>907,350</u>

368 BALANCE SHEET, SURPLUS, PROFIT AND LOSS

Consolidated statements: Second illustration.—The statement of cost of goods sold and the statement of profit and loss would be the same as those in the first illustration.

COMPANY A AND SUBSIDIARIES B AND C Exhibit B Consolidated Surplus Statement

For the Year Ended December 31, 1934

Surplus, December 31, 1933.....	\$31,850.00
Net Income for 1934.....	58,100.00
Total.....	<u>\$89,950.00</u>
Less Dividends Paid.....	30,000.00
Surplus, December 31, 1934.....	<u>\$59,950.00</u>

The payments of dividends affect the following items in the consolidated balance sheet: cash, minority interest, and consolidated surplus.

COMPANY A AND SUBSIDIARIES B AND C Exhibit A Consolidated Balance Sheet

December 31, 1934

Assets

Current Assets:

Cash.....	\$ 41,300.00
Accounts Receivable.....	84,200.00
Inventories:	
Raw Materials.....	\$82,390.00
Goods in Process.....	78,320.00
Finished Goods.....	<u>91,140.00</u>
	251,850.00

Total Current Assets..... \$377,350.00

Fixed Assets:

Land.....	\$ 95,000.00
Buildings—Less Depreciation.....	235,000.00
Machinery—Less Depreciation.....	<u>145,000.00</u>

Total Fixed Assets..... 475,000.00

Goodwill..... 15,000.00

\$867,350.00

Liabilities and Net Worth

Current Liabilities.

Accounts Payable..... \$166,700.00

Fixed Liabilities:

Bonds Payable—6%.....	\$100,000.00
Bonds Payable—5%.....	\$50,000.00
Less Bonds in Treasury.....	<u>40,000.00</u>
	10,000.00

Total Fixed Liabilities..... 110,000.00

Minority Interest..... 30,700.00

Net Worth:

Capital Stock.....	\$500,000.00
Surplus.....	<u>59,950.00</u>

Total Net Worth..... \$59,950.00

\$867,350.00

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 369

Third and fourth illustrations.—In the two following illustrations it is assumed that the parent company has carried the investments at cost. Adjustments are therefore necessary to take up the parent company's share of the increase in the surplus of each subsidiary since acquisition.

Third illustration. (*See working papers, pages 370 and 371.*)—This illustration is the same as the first illustration, except that the investments are carried at cost on the parent company's books.

Adjustment H: Increase in surplus of Company B since acquisition.

The increase in the surplus of Company B since the date of acquisition, and Company A's 90% interest therein, are determined as follows:

	COMPANY B SURPLUS	
	Total	Company A's 90%
Increase prior to 1934:		
Surplus, December 31, 1933.....	\$25,000.00	
Surplus, January 1, 1930, date of acquisition	15,000 00	
Increase prior to 1934.....	\$10,000.00	\$ 9,000.00
Increase during 1934—net income.. . . .	17,000.00	15,300.00
Total.....	\$27,000.00	\$24,300.00

The adjustments in the working papers are as follows:

	Section	Debit	Credit
Investment in Company B....	Assets	\$24,300	
Surplus (Company A).....	Surplus		\$ 9,000
Company B Profit (to take up the current year's income).....	P. & L.		15,300

The debit to the Investment account takes up Company A's 90% of the increase in the subsidiary's surplus since the date of acquisition. The credit to Surplus takes up, in the surplus of Company A, as of December 31, 1933, 90% of the increase in Company B's surplus between the date of acquisition and December 31, 1933. The credit to Company B Profit takes up, as income to Company A, 90% of B's profit for 1934.

In other words, by applying this adjustment in the working papers, Company A's accounts are adjusted to agree with those resulting from taking up subsidiary profits, losses, and dividends currently through the Investment account, as in the first illustration. The elimination of Company A's interest in the surplus of Company B on December 31, 1934 (elimination I) is therefore made as in the first illustration.

Working papers for third illustration.

COMPANY A AND SUBSIDIARIES B AND C
Consolidated Working Papers—Year Ended December 31, 1933

(Cost of Goods Sold Section—Same as in first illustration.)

	PROFIT AND LOSS			ADJUSTMENTS AND ELIMINATIONS		Minority	Consolidated
	Company A	Company B	Company C	Debit	Credit		
Gross Sales	300,000	225,000	120,000	170,000(A)			475,000
Less Returned Sales and Allowances	3,000	2,000	1,000				6,000
Net Sales	297,000	223,000	119,000				489,000
Less Cost of Goods Sold (Brought forward)	215,000	173,000	80,000	9,150	176,150		303,000
Gross Profit on Sales	82,000	48,000	39,000				169,000
Less Selling Expenses	23,000	22,000	15,000				60,000
Net Profit on Sales	59,000	26,000	24,000				109,000
Less General Expenses	24,000	9,000	3,000				36,000
Net Profit on Operations	35,000	17,000	21,000				70,000
Add Miscellaneous Income:							
Company B Profit—90%				15,300(I)	15,300(H)		
Company C Profit—80%				14,800(L)	14,800(K)		
Rent of Equipment to Company B	3,000			3,000(E)			
Bond Interest from Company C	2,000			2,000(F)			
Net Profit on Operations and Other Income	40,000	17,000	21,000				70,000
Less Bond Interest Paid	6,000		2,500				6,500
Net Income before Deduction of Minority Interests	34,000	17,000	18,500		2,000(F)		63,500
Minority Interests:							
Company B—10%						1,700	
Company C—20%						3,700	
Net Income (Forward)	34,000	17,000	18,500	214,250	208,250	5,400	58,100

SURPLUS

Surplus, December 31, 1933:							
Company A	26,000						
Add 90% of Increase in Company B's Surplus from Date of Acquisition to December 31, 1933							
Intercompany Profit in Inventories, December 31, 1933							
Adjusted Balance				3,150(C)	9,000(H)		31,850
Company B	25,000						
Company C		20,000					
Net Income (Brought forward)	34,000	17,000	18,500	214,250	208,250	5,400	58,100
Surplus, December 31, 1934	60,000	42,000	38,500	255,900	217,250	11,900	89,950

Assets						
Cash.....	40,000	16,000	16,500			72,500
Accounts Receivable.....	53,700	17,000	25,000	11,500(B)		84,200
Inventories:						
Raw Materials.....	50,000	25,000	11,000	3,610(D)		82,390
Goods in Process.....	55,000	25,000		1,630(D)		78,320
Finished Goods.....	45,000	50,000		3,860(D)		91,140
Land.....	50,000	20,000	25,000			96,000
Buildings—Less Depreciation.....	140,000	35,000	60,000			235,000
Equipment—Less Depreciation.....	90,000	40,000	15,000			145,000
Investment in Stock of Company B—90%—At cost.....	108,500					
Add 90% of Increase in Company B Surplus since Acquisition.....				24,300(H)		
Eliminate:						
Capital Stock.....					90,000(G)	
Surplus.....					37,800(I)	
Goodwill.....						5,000G
Investment in Stock of Company C—80%—At cost.....	66,000					
Add 80% of Increase in Company C Surplus since Acquisition.....				14,800(K)		
Eliminate:						
Capital Stock.....					40,000(J)	
Surplus.....					30,800(L)	
Goodwill.....	40,000					10,000G
Investment in Bonds of Company C.....	<u>738,200</u>	<u>228,000</u>	<u>152,500</u>			<u>40,000</u>
						<u>938,550</u>
LIABILITIES AND NET WORTH						
Accounts Payable.....	78,200	86,000	14,000	11,500(B)		166,700
Bonds Payable:						
Company A.....	100,000					100,000
Company C.....			50,000			50,000
Capital Stock:						
Company A.....	500,000					500,000
Company B.....		100,000				10,000
Company C.....		50,000	50,000			10,000
Surplus (Brought forward).....	60,000	42,000	38,500	255,900	217,250	89,950
Total Minority Interests.....	<u>738,200</u>	<u>228,000</u>	<u>152,500</u>	<u>436,500</u>		<u>31,900</u>
						<u>938,550</u>

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Adjustment K: Increase in surplus of Company C since acquisition.

The increase in the surplus of Company C since January 1, 1934, the date of acquisition, and Company A's 80% interest therein, are determined as follows:

	<u>COMPANY C SURPLUS</u>	
	<u>Total</u>	<u>Company A's 80%</u>
Net Profit, 1934.....	\$18,500.00	\$14,800.00

The adjustment is made as follows:

	<u>Section</u>	<u>Debit</u>	<u>Credit</u>
Investment in Company C	Assets	\$14,800.00	
Company C Profit.....	P. & L.		\$14,800.00

By applying this adjustment to the working papers, Company A's accounts are adjusted to agree with those resulting from taking up the subsidiary profits currently through the Investment account, as in the first illustration. The elimination of Company A's interest in the surplus of Company C on December 31, 1934 (elimination L) is therefore the same in this illustration as in the first illustration.

Consolidated statements: Third illustration.—The consolidated statements which would be prepared from the working papers of this illustration would not differ from those prepared from the working papers of the first illustration. These statements appear on pages 363 and 364.

Fourth illustration. (*See working papers, pages 374 and 375.*)—In this illustration it is assumed that dividends have been paid by all companies, as in the second illustration.

Investments are carried on the parent company's books at cost, as in the third illustration; adjustments H and K are therefore required, to take up the parent company's interest in the increase in the subsidiary surplus accounts since the date of acquisition.

Adjustments H and K are similar to those made in the third illustration, but a new element is introduced because of the fact that, in the present illustration, all companies are assumed to have paid dividends during the year.

Adjustment H: Increase in surplus of Company B since acquisition.

The increase in the surplus of Company B since the date of acquisition, and Company A's 90% thereof, are determined as follows:

BALANCE SHEET, SURPLUS, PROFIT AND LOSS 373

	COMPANY B SURPLUS	
	Total	Company A's 90%
Increase prior to 1934:		
Surplus, December 31, 1933.....	\$25,000	
Surplus, January 1, 1930, date of acquisition . . .	15,000	
Increase prior to 1934.....	\$10,000	\$ 9,000
Changes during 1934:		
Net Income.....	17,000	15,300
Dividends Paid.....	6,000*	5,400*
Total... ..	\$21,000	\$18,900

The adjustments in the working papers are as follows:

	Section	Debit	Credit
Investment in Company B Assets	Assets	\$18,900 00	
Dividends from Company B	P. & L.	5,400 00	
Company B Profit.....	P. & L.		\$15,300 00
Surplus.....	Surplus		9,000 00

The debit to the Investment account takes up Company A's 90% of the increase in the subsidiary's surplus since the date of acquisition. Company A has credited Dividends from Company B with the \$5,400.00 dividend received during the year, and regards this amount as income; the adjusting entry debits this account to eliminate it, and sets up, instead, the \$15,300.00 credit representing Company A's percentage of the income earned by the subsidiary during the year. The credit to Surplus takes up, in the surplus of Company A, as of December 31, 1933, 90% of the increase in Company B's surplus between the date of acquisition and December 31, 1933. In other words, by applying this adjustment in the working papers, Company A's accounts are adjusted to agree with those in the second illustration, resulting from taking up subsidiary profits, losses, and dividends currently through the Investment account. The elimination (I) of Company A's interest in the surplus of Company B on December 31, 1934, is therefore made as in the second illustration.

Adjustment K: Increase in surplus of Company C since acquisition.

The increase in the surplus of Company C since January 1, 1934, the date of acquisition, and Company A's 80% interest therein, are determined as follows:

	COMPANY C SURPLUS	
	Total	Company A's 80%
Net Profit for 1934.....	\$18,500.00	\$14,800.00
Dividends Paid.....	3,000.00*	2,400.00*
Net Increase.....	\$15,500.00	\$12,400.00

Working papers for fourth illustration.

COMPANY A AND SUBSIDIARIES B AND C

Consolidated Working Papers—Year Ended December 31, 1934

	PROFIT AND LOSS			ADJUSTMENTS AND ELIMINATIONS		Minority	Consolidated
	Com-pany A	Com-pany B	Com-pany C	Debit	Credit		
(Cost of Goods Sold Section—Same as in first illustration.)							
Gross Sales	300,000	225,000	120,000	170,000(A)			475,000
Returned Sales and Allowances	3,000	2,000	1,000				6,000
Net Sales	297,000	223,000	119,000				469,000
Less Cost of Goods Sold (Brought forward)	215,000	175,000	80,000	9,150	176,150		303,000
Gross Profit on Sales	82,000	48,000	39,000				169,000
Less Selling Expenses	23,000	22,000	15,000				60,000
Net Profit on Sales	59,000	26,000	24,000				109,000
Less General Expenses	24,000	9,000	3,000				36,000
Net Profit on Operations	35,000	17,000	21,000				70,000
Add Miscellaneous Income:							
Dividends from Company B	5,400			5,400(H)			
Company B Profit—90%				15,300(I)	15,300(H)		
Dividends from Company C	2,400			2,400(K)			
Company C Profit—80%				14,800(L)	14,800(K)		
Rent of Equipment to Company C	3,000			3,000(E)			
Bond Interest from Company C	2,000			2,000(F)			
Net Profit on Operations and Other Income	47,800	17,000	21,000		2,000(F)		70,000
Less Bond Interest Paid	6,000	17,000	2,500				6,500
Net Income before Deduction of Minority Interests	41,800	17,000	18,500				63,500
Minority Interests:							
Company B—10%						1,700	
Company C—20%						3,700	
Net Income (Forward)	41,800	17,000	18,500	222,050	208,250	5,400	58,100
SURPLUS							
Surplus, December 31, 1933:							
Company A	26,000						
Add 90% of Increase in Company B's Surplus from Date of Acquisition to December 31, 1933					9,000(H)		
Intercompany Profit in Inventories				3,150(C)			
Adjusted Balance							31,850
Company B	25,000		20,000	22,500(I)			2,500
Company C	41,800	17,000	18,500	16,000(L)			4,000
Net Income (Brought forward)	67,800	42,000	38,500	222,050	208,250	5,400	58,100
Total							89,950

Less Dividends Paid:									
Company A.....	30,000		6,000	3,000		5,400(L)	600*	30,000	
Company B.....						2,400(L)	600*		
Company C.....							10,700		
Surplus, December 31, 1934 (Forward).....	<u>37,800</u>	<u>36,000</u>	<u>3,500</u>	<u>263,700</u>	<u>225,050</u>			<u>59,950</u>	
Assets									
Cash.....	17,800	10,000	13,500					41,300	
Accounts Receivable.....	53,700	17,000	25,000			11,500(B)		84,200	
Inventories:									
Raw Materials.....	50,000	25,000	11,000			3,610(D)		82,390	
Goods in Process.....	55,000	25,000				1,680(D)		78,320	
Finished Goods.....	45,000	50,000				3,860(D)		91,140	
Land.....	50,000	20,000	25,000					95,000	
Buildings—Less Depreciation.....	140,000	35,000	60,000					235,000	
Equipment—Less Depreciation.....	90,000	40,000	15,000					145,000	
Investment in Stock of Company B—90% Add 90% of Increase in Company B's Surplus since Date of Acquisition Eliminate:	108,500			18,900()					
Capital Stock.....						90,000(G)			
Surplus.....						32,400(L)			5,000G
Goodwill.....									
Investment in Stock of Company C—80% Add 80% of Increase in Company C's Surplus since Date of Acquisition Eliminate:	66,000			12,400(K)					
Capital Stock.....						40,000(J)			
Surplus.....						28,400(L)			
Goodwill.....									
Investment in Bonds of Company C.....	40,000								
	<u>716,000</u>	<u>222,000</u>	<u>149,500</u>					<u>10,000G</u>	
	78,200	86,000	14,000	11,500(B)				<u>40,000</u>	
								<u>907,350</u>	
LIABILITIES AND NET WORTH									
Accounts Payable.....								166,700	
Bonds Payable:									
Company A.....								100,000	
Company C.....	100,000		50,000					50,000	
Capital Stock:									
Company A.....	500,000							500,000	
Company B.....									
Company C.....	100,000		50,000					10,000	
Surplus (Brought forward).....	37,800	36,000	36,500	263,700	225,050			59,950	
Total Minority Interest.....								30,700	
	<u>716,000</u>	<u>222,000</u>	<u>149,500</u>	<u>436,500</u>	<u>436,500</u>			<u>907,350</u>	

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The adjustment in the working papers is as follows:

	<u>Section</u>	<u>Debit</u>	<u>Credit</u>
Investment in Company C	Assets	\$12,400	
Dividends from Company C (to close)	P. & L.	2,400	
Company C Profit (to take up 80% of year's profit)			\$14,800

The elimination (L) of Company A's interest in the surplus of Company C on December 31, 1934, is the same as elimination L in the second illustration, on page 365.

Consolidated statements.—The consolidated statements prepared from the working papers of the fourth illustration would be the same as those prepared from the working papers of the second illustration.

Reserve for intercompany profit in inventories.—Instead of showing the inventories in the consolidated balance sheet at the net amounts after deducting the unrealized intercompany profit, it may be desired to show a reserve for intercompany profit in the balance sheet so as to indicate that a conservative accounting procedure has been followed in eliminating the intercompany profit. To accomplish this purpose, the inventories may be shown in the balance sheet as follows:

Inventories:		
Raw Materials	\$ 86,000.00	
Goods in Process	80,000.00	
Finished Goods	95,000.00	
Total	<u>\$261,000.00</u>	
Less Reserve for Intercompany Profit	<u>9,150.00</u>	\$251,850 00

If this procedure is to be followed in the consolidated balance sheet, the adjustment may be entered in the balance sheet papers in the manner already illustrated, or as shown on the opposite page.

Alternative form of working papers.—If consolidated statements are to be prepared from trial balances instead of from company statements, working papers in the form illustrated on pages 379 to 381 may be found more convenient than those previously illustrated. The working papers in the alternative form are based on the same assumed facts as those of the first illustration in this chapter. All of the adjustments and eliminations appearing in the working papers of the first illustration appear also in the working

Inventories, December 31, 1934:

	ADJUSTMENTS AND ELIMINATIONS			Minority	Consoli- dated
	Company A	Company B	Company C		
Raw Materials.....	50,000.00	25,000.00	11,000.00		86,000.00
Goods in Process.....	55,000.00	25,000.00			80,000.00
Finished Goods.....	45,000.00	50,000.00			95,000.00
Reserve for Intercompany Profit in Inventories..				9,150.00	9,150.00*

* Deduction.

papers in the alternative form, and bear the same identifying letters. Since the trial balances do not contain the closing inventories, another adjustment is necessary to introduce these inventories into the papers; this adjustment has been given the number 1 so that the other adjustments and eliminations in this illustration will carry the same letters as those in the first illustration. Normally, this inventory adjustment would carry a letter. Working papers in the alternative form are prepared as follows:

Enter the trial balances in the working papers, leaving room for eliminations after the Investment accounts and after the Capital Stock and Surplus accounts. Add the Trial Balance columns to detect any possible errors in copying.

Enter the adjustments and eliminations. The adjustment for the closing inventories includes debits which are extended to the Balance Sheet column, and credits which are extended (after elimination of intercompany profits) to the Cost of Sales column. Note that the inventories are listed in detail on the credit sheet in the Trial Balance columns so that they can be readily included in the nominal elements when the profit of each company is determined.

Extend the trial balance amounts, plus or minus adjustments, to the appropriate columns.

Determine the net profit of each company by totaling the nominal elements in the Trial Balance columns of the debit and credit sheets, and deducting the total debits from the total credits. This deduction appears on the credit sheet.

Foot the Adjustment and Elimination columns.

Determine the cost of sales by footing the Cost of Sales columns on the two sheets and deducting the total credits from the total debits. This deduction is made on the debit sheet, and the cost of sales is extended to the Profit and Loss column.

Determine the net profit for the year by footing the Profit and Loss columns on the two sheets and deducting the total debits from the total credits. This deduction is made on the credit sheet. The minority interests

COMPANY A AND SUBSIDIARIES B AND C

Consolidated Working Papers

For the Year Ended December 31, 1934

	ADJUSTMENTS AND ELIMINATIONS			BALANCE SHEET
	Debit	Credit	Good-will	
Debits				
Cash.....				
Accounts Receivable.....				
Inventories:				
Raw Materials.....	40,000	16,500		79,500
Goods in Process.....	53,700	23,500		84,200
Finished Goods.....	25,000			
Land.....	50,000			
Buildings—Less Depreciation.....	140,000	60,000		95,000
Equipment—Less Depreciation.....	90,000	15,000		259,000
Purchases.....	145,000	76,000		149,000
Direct Labor.....	85,000			
Manufacturing Expense.....	70,000			
Returned Sales and Allowances.....	3,000			
Selling Expenses.....	23,000			
General Expenses.....	24,000			
Bond Interest Paid.....	6,000			
Investment in Stock of Company B—90% ..	132,800			
Eliminate:				
Capital Stock.....				
Surplus.....				
Goodwill.....			5,000	
Investment in Stock of Company C—80% ..				
Eliminate:				
Capital Stock.....				
Surplus.....				
Goodwill.....			10,000	
Investment in Bonds of Company C.....	40,000			40,000
	<u>1,048,300</u>	<u>436,000</u>		
Inventories, December 31, 1934:				
Raw Materials.....				98,000
Goods in Process.....				80,000
Finished Goods.....				95,000
Total Debits to Nominal Accounts—Deducted contra	<u>421,000</u>	<u>308,000</u>		
Adjustment Column Totals (Forward)		<u>388,260</u>		
Total Debits to Cost of Sales.....				554,850
Less Total Credits to Cost of Sales—Per contra				251,850
Cost of Sales—To Profit and Loss.....				<u>303,000</u>
Total Debits to Profit and Loss—Deducted contra.....				411,500
Total Goodwill.....			<u>15,000</u>	<u>15,000</u>
				<u>947,700</u>

Consolidated Working Papers—(Continued)

	ADJUSTMENTS AND ELIMINATIONS				BALANCE SHEET				
	Com- pany A	Com- pany B	Com- pany C	Debit Credit	Cost of Sales	Profit and Loss	Minority Inter- est	Sur- plus	Sur- dry
Adjustment Totals (Forward)									
Accounts Payable	78,200	86,000	14,000	261,000	388,250				186,700
Bonds Payable:				11,500(B)					
Company A	100,000								100,000
Company C			50,000						50,000
Gross Sales	300,000	225,000	120,000	170,000(A)		475,000			
Rent of Equipment to Company B	3,000			3,000(E)					
Bond Interest from Company C	2,000			2,000(F)					
Capital Stock:									
Company A	500,000								500,000
Company B		100,000							
Eliminate Parent Company's 90%				90,000(G)			10,000		
Minority—10%									
Company C			50,000						
Eliminate Parent Company's 80%				40,000(J)			10,000		
Minority—20%									
Surplus—December 31, 1933:									
Company A	35,000								
Adjustment for Intercompany Profit in Opening Inventory				3,150(C)					31,850
Adjusted Surplus									
Company B		25,000							
Eliminate Parent Company's 90%				22,500(I)			2,500		
Minority—10%									
Company C			20,000						
Eliminate Parent Company's 80%				16,000(L)			4,000		
Minority—20%									
Company B Profit	15,300			15,300(I)					
Company C Profit	14,800			14,800(L)					
	<u>1,048,300</u>	<u>436,000</u>	<u>254,000</u>						
Inventories, December 31, 1934:									
Raw Materials	50,000	25,000	11,000	3,610(D)	86,000(I)				82,390
Goods in Process	55,000	25,000		1,680(D)	80,000(I)				78,320
Finished Goods	45,000	50,000		3,860(D)	95,000(I)				91,140
Reserve for Intercompany Profit in Dec. 31, 1934 Inv.									9,150
Total Credits to Nominal Accounts	<u>485,100</u>	<u>325,000</u>	<u>131,000</u>						

Less Debits to Nominal Accounts—Contra.	421,000	308,000	112,500		
Net Profit Per Books.....	<u>64,100</u>	<u>17,000</u>	<u>18,500</u>		
Total Credits to Cost of Sales—Deducted Contra....				<u>658,400</u>	
Total Credits to Profit and Loss.....					<u>251,850</u>
Total Debits to Profit and Loss—Per Contra.....					<u>475,000</u>
Net Profit for the Year.....					<u>411,500</u>
Minority Interest in Co. B—10% of \$17,000.00....					63,500
Minority Interest in Co. C—20% of \$18,500.00....					1,700*
Parent Company's Share of Net Profit.....					3,700*
Total Minority Interest.....					<u>58,100</u>
Total Surplus.....					<u>31,900</u>
					<u>81,900</u>
					<u>89,960</u>
					<u>947,700</u>

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are then deducted from the net profit and are entered in the Minority column; the parent company's interest in the net profit for the year is then extended to the Surplus column.

The total of the Goodwill column (debit sheet) and the totals of the Minority Interest and Surplus columns (credit sheet) are extended to the Balance Sheet columns, and the Balance Sheet columns are totaled.

Minority and Surplus columns may be used on the debit sheet if Deficit account balances appear on the debit side of the trial balances or if there are accounts with debit balances representing charges for dividend payments. Or, these debit balances may be entered in red ink on the credit sheet.

CHAPTER 51

CONSOLIDATIONS, MERGERS, AND FINANCING

Purposes of combinations.—The modern trend of business organization has been toward the combination of competing firms and corporations into consolidated or affiliated companies. Some doubt has been raised by economists, and particularly by sociologists, regarding the desirability of this trend, and many combinations have been forced to dissolve because the Federal courts have regarded them as “combinations in restraint of trade” and hence in violation of the Sherman Anti-Trust law. At the date of this writing, there appears to be less assurance of the social benefits of free competition, and an increasing inclination to sanction the reduction of competition but to increase the governmental control over industry.

Industrialists have generally held, although not without some dissenting voices, that combinations reduce costs and expenses, and hence increase profits. It is claimed that these advantages result from:

- (1) The reduction of competition in the buying market, thus tending to give the combination a certain measure of control over the costs of material and labor.
- (2) The enlargement of the scope of production, enabling the combination to:
 - (a) Own and operate the sources of its raw materials.
 - (b) Carry manufacture through successive stages, as in the case of a company owning timber lands, producing lumber, and manufacturing furniture.
 - (c) Process and market its own by-products.
 - (d) Obtain the benefits of division of labor among workmen and among plants, which is an incident of large-scale production.

- (3) The elimination of duplicate sales effort and expense.
- (4) The elimination of duplicate administrative effort and expense.
- (5) The increase in the control of sales prices which results from the elimination of competition in the selling market.
- (6) The increase in financing ability resulting from the increase in the amount of capital controlled and the more ready access to large sources of credit.

Methods of combining.—The devices which have been most frequently used in combining two or more corporations into a coördinated organization with a centralized control, or into a single company, are:

- (1) Methods of obtaining centralized control of several companies:
 - (a) Interlocking directorates.
 - (b) Voting trusts.
 - (c) Parent companies.
- (2) Methods of combining several companies into one company:
 - (a) Consolidation.
 - (b) Merger.

Interlocking directorates.—If companies whose operations are normally in competition with, or dependent upon, one another, have boards of directors which include members serving on more than one board, a certain degree of common control may be obtained. If there are enough directors in common, the policies of the several companies will be subject to the same direction, and may be determined on a basis of their mutual benefit.

Voting trusts.—At the beginning of the era of great combinations, the voting trust was one of the most popular methods of effecting a unified control of competing businesses. The stockholders of each company, or a majority thereof, transferred their stock certificates to trustees in exchange for certificates of beneficial interest in the trust. The trustees, holding voting control of the corporations, elected the directors of the corporations, and were thus able to control the activities of the companies as effectively as if the corporations

were a single company.

When the voting trust was held to be illegal, the attention of those interested in effecting or maintaining combinations was turned toward the parent, or holding, company.

Parent companies.—A parent company is a corporation which owns all, or a voting majority, of the stock of another corporation, and is thus in a position to control that corporation by electing its board of directors.

If several companies are to be combined by means of a parent company, a new corporation may be organized to act in that capacity, or one of the old companies may acquire the stock of the other companies. The stockholders who sell their stock to the parent company may be paid in cash or in securities of the parent company. In either case, the parent company purchases the stock of the companies to be controlled, but does not purchase their assets or assume their liabilities. Therefore the controlled companies remain in existence and in the possession of their properties; so far as they are concerned, the only change made is the change in the personnel of their stockholders.

Consolidations and mergers.—If the combination is effected by a consolidation or a merger, several companies may be replaced by a single company which will own all of the assets formerly owned by the old companies, and owe all of the debts which the old companies formerly owed. Certain assets and liabilities may be left with the old companies, but this does not affect the general nature of the consolidation or the merger. Payment for the net assets acquired may be made in cash or by the issuance of stock or other securities.

A distinction is sometimes made between a consolidation and a merger, as follows:

A consolidation is effected if a new corporation is organized which buys the assets and assumes the liabilities of the old companies.

A merger is effected if one of the old corporations buys the assets and assumes the liabilities of the others.

This distinction, however, is not usually recognized, and the two terms are generally used interchangeably.

Net assets and net earnings.—If a combination of two or more companies is contemplated, it may be promoted by outsiders who desire to obtain the companies, or it may be promoted by the companies themselves. In either instance, consideration should be given to the value of the net assets and the amount of the net earnings of the several companies.

If the combination is being promoted by the companies themselves, a consolidation committee should be organized, consisting of members from all of the companies. This committee, with the assistance of an appraiser, an accountant, and an attorney, should submit a report embodying statements of the net assets and the net earnings of each company, and the proposed method of effecting the combination.

The accountant, after making audits of all companies, should submit a balance sheet of each company, stating the values at which it is proposed to take over the assets, and the liabilities to be assumed. The balance sheet should show the fixed assets at values determined by the appraiser, and the inventories at values determined by the appraiser or the committee.

The accountant should also submit income and surplus statements for the several companies. In preparing the income statements, the accountant should give consideration to the following matters:

(1) Number of years to be covered.

Profit and loss statements should be submitted for several years, in order to show the trend of profits; the value of the goodwill of each company depends, to some extent, upon whether its profits have been uniform year after year, or have steadily increased or decreased, or have fluctuated from year to year. Moreover, one year's statement may not be a fair basis for goodwill valuation because the year may have been characterized by extraordinary conditions.

(2) Correctness of the profits.

Adjustments may have to be made in the statements prepared by the companies themselves because errors have been made, such as:

(a) Incorrect distributions between capital and revenue.

(b) Failure to make provision for depreciation.

bad debts, and other expenses.

- (c) Failure to provide adequate repairs.
 - (d) Anticipation of profits on consignments, and so forth.
- (3) Uniformity of bases of computing profits.
- (a) Methods of computing manufacturing costs may have differed in the several companies; if possible, the cost statements should be revised and put on a uniform basis.
 - (b) Depreciation may have been computed by different methods. For instance, one company may have used the straight-line method and another the diminishing-value method; each may eventually provide adequate depreciation, but the annual charges will not be on a uniform basis.
 - (c) Management salaries may have differed widely in amount, and may require adjustment to a common basis.
 - (d) If a partnership is to be included in the consolidation, and if interest on capital has been treated as an expense in the profit and loss statements, the interest should be added back to the profits.
- (4) Adjustments from a historical basis to a prospective basis.

The actual operating profits of the past may differ from those which can be expected in the future under consolidated conditions. For example:

- (a) Depreciation charges in the past have presumably been based on cost; in the future they will be based on the appraised values at which the assets are acquired by the consolidated company. If the depreciation charges are thereby increased, the profits will be correspondingly decreased; it would seem, therefore, that the prospective depreciation charges should be applied retroactively to the statements for prior years.
- (b) It is often stated that interest on borrowed capital should not be included as an expense,

in determining the profits which are to be taken as a basis for goodwill valuation. If this theory is accepted, the statements should show the net income before deduction of interest. However, the author questions this theory, for reasons fully discussed in Chapter 18.

Payments for acquired companies.—After an agreement has been reached, and accepted by all companies, concerning the net asset values and the earnings of each company to be used as a basis for consolidation, the manner of payment remains for consideration. Payment may be made, in whole or in part, in:

- Common stock.
- Preferred stock.
- Bonds.
- Cash.
- Short-term obligations.

Some matters to be borne in mind before a decision is made regarding the mode of payment are discussed and illustrated on the following pages.

Basis of illustrations.—For purposes of illustration let us assume the following facts with respect to three companies:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Net Assets:				
Assets:				
Fixed.....	\$150,000	\$150,000	\$100,000	\$ 400,000
Other.....	150,000	275,000	575,000	1,000,000
Total assets.....	<u>\$300,000</u>	<u>\$425,000</u>	<u>\$675,000</u>	<u>\$1,400,000</u>
Liabilities.....	100,000	125,000	175,000	400,000
Net assets.....	<u>\$200,000</u>	<u>\$300,000</u>	<u>\$500,000</u>	<u>\$1,000,000</u>
Per cent of each company's net assets to total net assets.....	<u>20%</u>	<u>30%</u>	<u>50%</u>	<u>100%</u>
Annual Net Earnings:				
Amount of net earnings.....	\$ 30,000	\$ 30,000	\$ 40,000	\$ 100,000
Per cent of each company's net earnings to total net earnings.....	30%	30%	40%	100%
Per cent of each company's net earnings to its net assets.....	<u>15</u>	<u>10</u>	<u>8</u>	

Interests in net assets and net earnings.—To effect an equitable consolidation of the three companies, consideration should be given to the portion of the total net assets and the portion of the total net earnings contributed by each company. These portions are:

	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>
Per cent of total net assets.....	20%	30%	50%
Per cent of total net earnings.....	30	30	40

But how can the stockholders of Company A, for instance, obtain a 20% interest in the net assets of the consolidation and a 30% interest in its earnings? And how can the stockholders of Company C obtain a 50% interest in the consolidated net assets but only a 40% interest in its net earnings?

Such a theoretically desirable distribution of equities in the consolidated company may be impracticable or impossible, but it should always be remembered that consolidating companies are contributing net assets and net earnings, and that the ratio of each company's net assets to the total net assets, and the ratio of each company's net earnings to the total net earnings, should be given full consideration in determining the payments, in securities or otherwise, to be made to each company or its stockholders.

Illustrations.—The following cases illustrate some of the principles involved in the distribution of securities incident to a consolidation. The securities may be issued to the consolidating companies, or directly to their stockholders; in the discussion of the cases, we may therefore refer to the stockholders, or to the companies as representative of their stockholders. In testing the equity of the stock distributions from the standpoint of interests in net earnings, we shall assume that all of the annual earnings of the consolidation are distributed in dividends.

Payment in common stock only.—If payment to the consolidating companies is made in common stock only, proper recognition cannot be given to the fact that a company does not contribute the same per cent of net assets and of net earnings. This point is demonstrated by the first three cases.

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Case 1: COMMON STOCK ISSUED IN THE RATIO OF NET ASSETS.—If common stock of a par or stated value of \$1,000,000.00 is issued to the three companies (see foregoing statement of assumed facts) in amounts proportionate to their net assets, each old company will receive an equitable interest in the net assets of the consolidation. But the interests in future earnings will not be proportionate to the past earnings of the three companies, as shown by a comparison of the future and past distributions of earnings of \$100,000.00:

	Com- pany A	Com- pany B	Com- pany C	Total
Per cent of stock held.....	20 %	30 %	50 %	100 %
Distribution of consolidated earnings	\$20,000	\$30,000	\$50,000	\$100,000
Distribution of past earnings.....	30,000	30,000	40,000	100,000
Disadvantage to Company A.....	\$10,000			
Advantage to Company C.....			\$10,000	

Case 2: COMMON STOCK EQUAL TO NET ASSETS, ISSUED IN RATIO OF FORMER EARNINGS.—If we now assume that common stock of a par or stated value of \$1,000,000.00, the amount of the net assets, is issued to the old companies in amounts proportionate to their net earnings (instead of in proportion to their net assets, as in Case 1), the old companies will obtain equitable interests in the future earnings of the consolidation. But their interests in the consolidated net assets will not be equal to the net assets contributed by them, as shown below:

	Com- pany A	Com- pany B	Com- pany C	Total
Stock acquired, and interest in con- solidated net assets.....	\$300,000	\$300,000	\$400,000	\$1,000,000
Net assets contributed.....	200,000	300,000	500,000	1,000,000
Advantage to Company A.....	\$100,000			
Disadvantage to Company C.....			\$100,000	

Case 3: COMMON STOCK ISSUED TO EACH COMPANY FOR ITS NET ASSETS AND GOODWILL.—The inequities resulting from using common stock only cannot be eliminated by basing the common stock issue upon the amount of the net assets plus an allowance for goodwill based on earnings. To illustrate, let us assume that the goodwill of each company is determined by capitalizing its net earnings at, say, 8%, and by deducting the net assets from the capitalized value thus obtained, as follows:

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	<u>Earn-ings</u>	<u>Divide-By</u>	<u>Capitalized Value of Earnings</u>	<u>Deduct Net Assets</u>	<u>Good-will</u>
Company A	\$30,000	.08	\$ 375,000	\$ 200,000	\$175,000
Company B.	30,000	.08	375,000	300,000	75,000
Company C	40,000	.08	500,000	500,000	—
			<u>\$1,250,000</u>	<u>\$1,000,000</u>	<u>\$250,000</u>

And let us further assume that common stock is issued for the total of the net assets and goodwill of each company, or, in other words, in amounts equal to the capitalized value of the earnings. Since these amounts are proportionate to the nets earnings, an equitable distribution of stock from the earnings standpoint will be obtained. But an equitable distribution of stock from the net assets standpoint is not obtained, as may be proved by the following table showing the distribution of assets in liquidation, on the assumption that the net assets at that time total \$1,000,000.00, or the amount of the net assets contributed.

	<u>Com-pany A</u>	<u>Com-pany B</u>	<u>Com-pany C</u>	<u>Total</u>
Stock owned	\$375,000	\$375,000	\$500,000	\$1,250,000
Per cent of stock owned	<u>30 %</u>	<u>30 %</u>	<u>40 %</u>	<u>100 %</u>
Distribution of assets, in ratio of stock owned	\$300,000	\$300,000	\$400,000	\$1,000,000
Net assets contributed	200,000	300,000	500,000	1,000,000
Advantage to Company A	\$100,000			
Disadvantage to Company C			\$100,000	

Preferred and common stocks.—Since common stock cannot be issued in both the net asset ratio and the net earnings ratio, it may be desirable to issue preferred and common stocks in amounts determined as follows:

- (1) The total preferred and common shares should be allotted to the several companies in the ratio of the net earnings contributed.
- (2) The preferred stock should be preferred as to assets as well as to dividends, it should be fully participating with the common, and it should be allotted to the several companies in the ratio of their contributed net assets.
- (3) The number of shares of common stock to be allotted to each company should be determined by sub-

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tracting the number of preferred shares to be allotted to it (as determined in 2) from the total number of shares to be allotted to it (as determined in 1).

Case 4: PREFERRED STOCK FOR NET ASSETS; COMMON STOCK FOR GOODWILL.—One illustration of the above-described procedure is shown by the following allotment of 5% preferred stock and common stock, both with a par value of \$100.00 per share. The total par value of the stock to be issued is determined by capitalizing the earnings at the 5% rate applicable to the preferred stock. The use of other rates is discussed in a subsequent section.

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Net earnings.	<u>\$ 30,000</u>	<u>\$ 30,000</u>	<u>\$ 40,000</u>	<u>\$ 100,000</u>
Total par value of preferred and common stocks to be issued, computed by capitalizing the earnings at 5%.	\$600,000	\$600,000	\$800,000	\$2,000,000
Deduct preferred stock—to be issued for net assets.	<u>200,000</u>	<u>300,000</u>	<u>500,000</u>	<u>1,000,000</u>
Common stock—to be issued for goodwill.	<u>\$400,000</u>	<u>\$300,000</u>	<u>\$300,000</u>	<u>\$1,000,000</u>

Since the preferred stock is preferred as to assets, and is issued in amounts proportionate to the net assets contributed, the stockholders of the three companies are given equitable interests in the net assets. Liquidation of the consolidated company at a time when its net assets equaled \$1,000,000.00, the amount contributed, would result in returning to the stockholders of the three companies assets equal to the net assets contributed by them.

Let us now see whether the stock allotment also results in an equitable distribution of earnings, remembering that the earnings were contributed in the following amounts:

	<u>Amount</u>	<u>Per Cent of Total</u>
Company A.	\$ 30,000.00	30 %
Company B.	30,000.00	30
Company C.	40,000.00	40
Total.	<u>\$100,000.00</u>	<u>100 %</u>

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First, we shall assume that the earnings after consolidation were exactly equal to those before consolidation. The distribution of earnings would be:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Preferred dividends:				
5% of \$200,000.....	\$10,000			
5% of 300,000.....		\$15,000		
5% of 500,000.....			\$25,000	
Total preferred dividends.....				\$ 50,000
Common dividends:				
5% of \$400,000.....	20,000			
5% of 300,000.....		15,000		
5% of 300,000.....			15,000	
Total common dividends.....				50,000
Total, equal in each case to the earnings of the predecessor company.....	<u>\$30,000</u>	<u>\$30,000</u>	<u>\$40,000</u>	<u>\$100,000</u>

Second, let us assume that the earnings after consolidation were 50% greater than those before consolidation. Since the preferred stock participates fully with the common, the earnings would provide for a 7½% dividend on each class of stock. The distribution of earnings would be:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Preferred dividends:				
7½% of \$200,000.....	\$15,000			
7½% of 300,000.....		\$22,500		
7½% of 500,000.....			\$37,500	
Total preferred dividends.....				\$ 75,000
Common dividends:				
7½% of \$400,000.....	30,000			
7½% of 300,000.....		22,500		
7½% of 300,000.....			22,500	
Total common dividends.....				75,000
Total, equal in each case to 150% of the earnings of the predecessor company.....	<u>\$45,000</u>	<u>\$45,000</u>	<u>\$60,000</u>	<u>\$150,000</u>

It thus appears that an equitable distribution of earnings will be obtained if the earnings after consolidation are equal to, or in excess of, those of the predecessor companies. If the earnings after consolidation are less than those before consolidation, a lack of equity may develop in the distribution of profits, because the preferred dividends, constituting a first claim against the earnings, are distributed in the net asset ratio instead of in the earnings ratio.

To illustrate, assume that the earnings after consolidation

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were only \$80,000.00. This amount will provide for a 5% dividend on the preferred stock, but only a 3% dividend on the common stock. Therefore the distribution of earnings would be:

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends:				
5% of \$200,000.....	\$10,000			
5% of 300,000		\$15,000		
5% of 500,000			\$25,000	
Total preferred dividends.....				\$50,000
Common dividends:				
3% of \$400,000.....	12,000			
3% of 300,000		9,000		
3% of 300,000			9,000	
Total common dividends.....				30,000
Total.....	<u>\$22,000</u>	<u>\$24,000</u>	<u>\$34,000</u>	<u>\$80,000</u>
Share of earnings after consolidation ...	27 5%	30%	42 5%	100 %
Share of earnings before consolidation ..	<u>30.0</u>	<u>30</u>	<u>40.0</u>	<u>100</u>
Disadvantage to Company A.....	2 5%			
Advantage to Company C.....			2.5%	

This inequitable distribution of earnings could be avoided by making the preferred stock preferred as to assets only, with no preference as to dividends, but with the right to full participation with the common in all dividends. If the preferred stock were of this nature, the distribution of \$80,000.00 of earnings would be:

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends at 4%.....	\$ 8,000	\$12,000	\$20,000	\$40,000
Common dividends at 4%	16,000	12,000	12,000	40,000
Total.....	<u>\$24,000</u>	<u>\$24,000</u>	<u>\$32,000</u>	<u>\$80,000</u>
Share of earnings after consolidation ...	30%	30%	40%	100 %
Share of earnings before consolidation ..	<u>30</u>	<u>30</u>	<u>40</u>	<u>100</u>

It may be contended, however, that the issuance of such preferred stock would not be equitable, because adequate recognition is not given to assets contributed unless the preferred stock issued therefor assures its holders dividends at a reasonable rate, even though the consolidated earnings are not sufficient to pay a comparable dividend on the common stock issued for goodwill. And, from the standpoint of practical considerations, it would probably be undesirable to eliminate the feature of preference as to dividends, because of the adverse effect upon the marketability of the stock.

Preferred stock should be fully participating.—If the preferred stock is non-participating, an inequitable distribution of earnings may result.

Case 5: NON-PARTICIPATING PREFERRED STOCK.—Assuming the same distribution of preferred and common stocks as in Case 4, except that the preferred stock is non-participating, and assuming that the profits after consolidation are 150% of those before consolidation, the distribution of earnings will be as follows:

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends:				
5% of \$200,000.	\$10,000			
5% of 300,000.		\$15,000		
5% of 500,000.			\$25,000	
Total preferred dividends.				\$ 50,000
Common dividends:				
10% of \$400,000.	40,000			
10% of 300,000.		30,000		
10% of 300,000.			30,000	
Total common dividends.				100,000
Total.	<u>\$50,000</u>	<u>\$45,000</u>	<u>\$55,000</u>	<u>\$150,000</u>
Share of earnings after consolidation.	<u>33⅓%</u>	<u>30%</u>	<u>36⅔%</u>	<u>100%</u>
Share of earnings before consolidation. .	30	30	40	100
Advantage to Company A.	3⅓%			
Disadvantage to Company C.			3⅓%	

Use of stock without par value.—The use of par value common stock in Case 4 resulted in placing a very large value on the goodwill. The balance sheet in Case 4, immediately after the consolidation was effected, would appear as follows:

Balance Sheet			
Net Assets.	\$1,000,000.00	Preferred Stock.	\$1,000,000.00
Goodwill.	1,000,000.00	Common Stock.	1,000,000.00
	<u>\$2,000,000.00</u>		<u>\$2,000,000.00</u>

Such a disproportionate goodwill valuation may be avoided by using common stock without par value.

Case 6: COMMON STOCK WITHOUT PAR VALUE.—Instead of issuing 10,000 shares of par value common stock, as in Case 4, the same number of shares might be issued without par value, but with a small stated value, such as \$1.00 or \$5.00 per share. But, to insure an equitable distribution of earnings, the no-par common stock should have the same dividend rights per share as those of the par value stock issued in Case 4.

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Case 7: PREFERRED STOCK WITHOUT PAR VALUE.—The stock distribution in both Case 4 and Case 6 is subject to the possible criticism that the balance sheet indicates the existence of no asset value other than goodwill behind the common stock. The basis for this criticism can be eliminated by using no-par preferred stock as well as no-par common stock. The same numbers of preferred and common shares should be issued as in Cases 4 and 6, and the preferred stock should be given a liquidating value of \$100.00 per share. But a smaller nominal value could be assigned to the preferred stock, and the excess of the net assets over the nominal value of the preferred stock could be set up as the nominal value of the common stock. To illustrate, assume that no goodwill value is placed on the books of the consolidated company and that the preferred stock is given a nominal value of \$60.00 per share. The balance sheet immediately after consolidation will appear as follows:

Assets	
Net Assets.....	\$1,000,000.00
Net Worth	
Preferred Stock—10,000 shares; liquidating value, \$100.00 per share; stated value, \$60.00 per share.....	\$ 600,000.00
Common Stock—10,000 shares, at a stated value of \$40.00 per share	400,000.00
	\$1,000,000.00

The dividend rights of the two classes of stock should be the same as in Case 4: the preferred should be entitled to a preference dividend of \$5.00 per share, and to full participation with the common after a dividend of \$5.00 per share has been paid on the common stock.

The use of no-par stock does not destroy the equitable distribution of earnings and asset interests, as shown below:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Interests in Earnings:				
Number of preferred shares.....	2,000	3,000	5,000	10,000
Number of common shares.....	4,000	3,000	3,000	10,000
Total.....	6,000	6,000	8,000	20,000
Per cent of stock owned, and consequent participation in earnings.....	30%	30%	40%	100%
Per cent of earnings contributed	30	30	40	100

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Interests in Net Assets:

Number of shares of preferred	<u>2,000</u>	<u>3,000</u>	<u>5,000</u>	<u>10,000</u>
Liquidating value at \$100.00 per share	\$200,000	\$300,000	\$500,000	\$1,000,000
Net assets contributed	<u>200,000</u>	<u>300,000</u>	<u>500,000</u>	<u>1,000,000</u>

Determining total preferred and common shares.—Any method may be used for determining the total preferred and common shares to be issued, provided that:

- (1) The aggregate dividend rights of the total shares allotted to the several companies are proportionate to the earnings contributed.
- (2) The par or liquidating value of the preferred stock issued to each company is equal to the net assets contributed.

In Case 4, the total stock to be issued was determined by capitalizing the earnings of each company at 5%, the preference rate of the preferred stock. Other rates may, of course, be used for the preferred stock, and for capitalizing the net income, but:

The rate used in capitalizing the earnings should be not less than the preferred dividend rate, nor more than the lowest rate earned by any company on its net assets.

The application of this rule is illustrated by the three following cases.

Case 8: PREFERRED RATE, 6%; EARNINGS CAPITALIZED AT 8%.—This case conforms to the rule just stated; the capitalization rate, 8%, is not less than the 6% preferred dividend rate, nor more than the lowest rate earned by any company. (Company C earned 8%.) It will be assumed that the stock is given a par value of \$100.00 per share; previous cases have shown that no-par stock might be used. The stock distribution is shown below:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Net earnings	\$ 30,000	\$ 30,000	\$ 40,000	\$ 100,000
Total par of preferred and common stocks to be issued, computed by capitalizing net earnings at 8%	\$375,000	\$375,000	\$500,000	\$1,250,000
Preferred stock—for net assets	200,000	300,000	500,000	1,000,000
Common stock—for goodwill	<u>\$175,000</u>	<u>\$ 75,000</u>	<u>—</u>	<u>\$ 250,000</u>

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Equitable interests in the net assets are given to the three companies, because the preferred stock issued to them is equal to the net assets contributed. Let us now test the equity of the stock allotment from the earnings standpoint.

First, assume that the earnings after consolidation are the same as before, \$100,000.00. The preferred and common stocks will total 12,500 shares; since the preferred participates fully with the common, the earnings will provide for dividends of \$8.00 per share on the two classes of stock. The distribution of earnings will therefore be:

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends:				
8 % of \$200,000	\$16,000			
8 % of 300,000		\$24,000		
8 % of 500,000			\$40,000	
Total preferred dividends				\$ 80,000
Common dividends:				
8 % of \$175,000	14,000			
8 % of 75,000		6,000		
Total common dividends				20,000
Total—equal in each case to earnings before consolidation	<u>\$30,000</u>	<u>\$30,000</u>	<u>\$40,000</u>	<u>\$100,000</u>

Second, assume that the earnings after consolidation are \$150,000.00. The distribution thereof will be:

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends:				
12 % of \$200,000	\$24,000			
12 % of 300,000		\$36,000		
12 % of 500,000			\$60,000	
Total preferred dividends				\$120,000
Common dividends:				
12 % of \$175,000	21,000			
12 % of 75,000		9,000		
Total common dividends				30,000
Total	<u>\$45,000</u>	<u>\$45,000</u>	<u>\$60,000</u>	<u>\$150,000</u>
Share of earnings after consolidation	30 %	30 %	40 %	100 %
Share of earnings before consolidation	<u>30</u>	<u>30</u>	<u>40</u>	<u>100</u>

Case 9: PREFERRED RATE, 6%; EARNINGS CAPITALIZED AT 5%.—This case does not conform to the stated rule; the capitalization rate is less than the preferred dividend rate. The distribution of stock will be as follows:

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	Com- pany A	Com- pany B	Com- pany C	Total
Net earnings.....	\$ 30,000	\$ 30,000	\$ 40,000	\$ 100,000
Total par of preferred and common stocks to be issued, computed by capitalizing net earnings at 5%	\$600,000	\$600,000	\$800,000	\$2,000,000
Preferred stock—for net assets....	200,000	300,000	500,000	1,000,000
Common stock—for goodwill.....	\$400,000	\$300,000	\$300,000	\$1,000,000

Since the preferred stock is issued on the basis of net assets, equitable interests in the net assets are maintained. To test the equity of the distribution of earnings, assume that the consolidated profits are \$100,000.00, as they were before the consolidation. These would be sufficient to pay an average dividend of 5% on the total stock. But the preferred rate is 6%, and hence only 4% can be paid on the common stock.

	Com- pany A	Com- pany B	Com- pany C	Total
Preferred dividends:				
6% of \$200,000.....	\$12,000			
6% of 300,000.....		\$18,000		
6% of 500,000.....			\$30,000	
Total preferred dividends.....				\$ 60,000
Common dividends:				
4% of \$400,000.....	16,000			
4% of 300,000.....		12,000		
4% of 300,000.....			12,000	
Total common dividends.....				40,000
Totals—Shares of consolidated income..	\$28,000	\$30,000	\$42,000	\$100,000
Net earnings contributed.....	30,000	30,000	40,000	100,000
Disadvantage to Company A.....	\$ 2,000			
Advantage to Company C.....			\$ 2,000	

To obtain an equitable distribution of earnings, the profits must be adequate to provide for a dividend at a uniform rate on both classes of stock; since the preferred bears 6%, the required profits are 6% of \$2,000,000.00, or \$120,000.00. If profits of that amount are made, the distribution will be:

	Com- pany A	Com- pany B	Com- pany C	Total
Dividends on both classes of stocks at 6%:				
6% of \$600,000.....	\$36,000			
6% of 600,000.....		\$36,000		
6% of 800,000.....			\$48,000	
Total.....				\$120,000
Share of earnings after consolidation....	30%	30%	40%	100%
Share of earnings before consolidation...	30	30	40	100

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Case 10: PREFERRED RATE, 6%; EARNINGS CAPITALIZED AT 10%.—This case also fails to conform to the stated rule, because the capitalization rate, 10%, is greater than the 8% rate earned by Company C on its net assets. The distribution of stock will be:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Net earnings.	<u>\$ 30,000</u>	<u>\$ 30,000</u>	<u>\$ 40,000</u>	<u>\$ 100,000</u>
Total par of preferred and common stocks to be issued, computed by capitalizing earnings at 10% . . .	\$300,000	\$300,000	\$400,000	\$1,000,000
Preferred stock—for net assets. . . .	200,000	300,000	500,000	1,000,000

The inequity of this procedure immediately becomes apparent. Company C is entitled to preferred stock of a par (or liquidating) value of \$500,000.00 for its net assets; but since the earnings were capitalized at a rate greater than that earned by Company C, the total stock allotted to it was only \$400,000.00.

Problem of a company with low earnings.—A difficult problem arises if one company's rate of earnings has been considerably less than a reasonable preferred dividend rate. Assume, for example, the following facts with respect to Company D:

Net assets.	\$300,000.00
Net earnings.	6,000.00
Rate of net earnings on net assets.	2%

If the consolidated company issues 6% preferred stock for the net assets, the allotment to this company of \$300,000.00 of preferred stock for its net assets will entitle it to dividends of \$18,000.00, although it contributed only \$6,000.00 of earnings to the consolidation. If the company is given only \$100,000.00 of preferred stock, an amount sufficient to entitle it to dividends of \$6,000.00, it will not receive adequate consideration for the net assets contributed.

This condition might be met by the issuance of a special class of preferred stock with a low dividend rate, but such a solution would usually be impracticable. Some compromise probably would be necessary, such as the issuance of preferred stock of a smaller amount than that indicated by the net assets, but of a larger amount than that indicated by the earnings. For instance, in the above case, the company

might receive 6% preferred stock of a par value of \$200,000.00, carrying a dividend right of \$12,000.00. As a compensation for its sacrifice from the net asset standpoint, the company would obtain an advantage from the earnings standpoint.

The use of bonds.—Stockholders considering the consolidation of their company with other companies sometimes desire to be paid partly in bonds secured by the fixed assets. The bonds rank ahead of general, unsecured creditors; they entitle their holders to interest regardless of profits; and they may be sold to obtain funds without parting with stock interests. While these may be advantages, the use of bonds involves a difficulty in maintaining an equitable distribution of earnings if the consolidated earnings differ from those of the predecessor companies.

We have seen that an equitable distribution of earnings requires that the preferred stock be fully participating with the common. Unless the bonds are similarly participating (a most unusual feature of bonds), a stockholder who accepts a 6% bond instead of a share of 6% participating preferred stock, is giving up a right to participate in excess profits in exchange for such benefits as may accrue to him from the possession of bonds. And if the bonds bear a lower rate than the preferred stock, a further loss of income is suffered.

Case 11: BONDS, PREFERRED STOCK, AND COMMON STOCK.—Let us assume that Companies *A*, *B*, and *C* are consolidated by issuance of:

- 5% bonds, of a par value equal to 80% of the fixed assets.
- 6% preferred stock for the remainder of the net assets.
- Common stock for goodwill, based on the profits contributed in excess of bond interest and preferred dividends to be received.

The allotment of securities may be determined as follows:

	Com- pany <i>A</i>	Com- pany <i>B</i>	Com- pany <i>C</i>	Total
Fixed assets.....	\$150,000	\$150,000	\$100,000	\$ 400,000
Net assets.....	200,000	300,000	500,000	1,000,000
Earnings.....	30,000	30,000	40,000	100,000
Bonds—80% of fixed assets.....	<u>\$120,000</u>	<u>\$120,000</u>	<u>\$ 80,000</u>	<u>\$ 320,000</u>
Preferred stock—remainder of net assets.....	80,000	180,000	420,000	680,000
Common stock (see page 402).....	<u>320,000</u>	<u>220,000</u>	<u>180,000</u>	<u>720,000</u>

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The computation of the allotment of common stock is shown below:

Net earnings.....	\$ 30,000	\$ 30,000	\$ 40,000	\$ 100,000
Deduct: Bond interest—5%....	\$ 6,000	\$ 6,000	\$ 4,000	\$ 16,000
Preferred dividend—6%..	4,800	10,800	25,200	40,800
Total.....	<u>\$ 10,800</u>	<u>\$ 16,800</u>	<u>\$ 29,200</u>	<u>\$ 56,800</u>
Remainder of earnings contributed —distribution thereof to be pro- vided by issuance of common stock.....	\$ 19,200	\$ 13,200	\$ 10,800	\$ 43,200
Par value of common stock, com- puted by capitalizing remaining earnings at 6%.....	<u>\$320,000</u>	<u>\$220,000</u>	<u>\$180,000</u>	<u>\$ 720,000</u>

A 6% capitalization rate is used in determining the par value of the common stock to be issued, because this is the preference rate for the preferred stock.

If the earnings after consolidation are the same as those prior to consolidation, the earnings distributed to the former stockholders of the three companies will be the same as the former earnings of the three companies, as shown below:

	Com- pany A	Com- pany B	Com- pany C	Total
Bond interest:				
5% of \$120,000	\$ 6,000			
5% of 120,000		\$ 6,000		
5% of 80,000			\$ 4,000	
Total bond interest				\$ 16,000
Preferred dividends:				
6% of \$ 80,000	4,800			
6% of 180,000		10,800		
6% of 420,000			25,200	
Total preferred dividends				40,800
Common dividends:				
6% of \$320,000	19,200			
6% of 220,000		13,200		
6% of 180,000			10,800	
Total common dividends				43,200
Totals—same as before consolidation...	<u>\$30,000</u>	<u>\$30,000</u>	<u>\$40,000</u>	<u>\$100,000</u>

But let us now assume that the profits after consolidation increase to \$296,000.00, and note the effect of the bonds (which bear 5% interest, without further participation in profits) upon the distribution of the earnings. The bond interest totals \$16,000.00, leaving \$280,000.00 for dividends on the preferred and common stocks. Since these two classes of stock have an aggregate par value of \$1,400,000.00, and since the preferred is fully participating, each class of stock has

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earned 20%. The distribution of the profits, including bond interest, is shown below:

	<u>Com- pany A</u>	<u>Com- pany B</u>	<u>Com- pany C</u>	<u>Total</u>
Bond interest:				
5% of \$120,000.....	\$ 6,000			
5% of 120,000.....		\$ 6,000		
5% of 80,000.....			\$ 4,000	
Total bond interest.....				\$ 16,000
Preferred dividends:				
20% of \$ 80,000.....	16,000			
20% of 180,000.....		36,000		
20% of 420,000.....			84,000	
Total preferred dividends.....				136,000
Common dividends:				
20% of \$320,000.....	64,000			
20% of 220,000.....		44,000		
20% of 180,000.....			36,000	
Total common dividends.....				144,000
Total.....	<u>\$86,000</u>	<u>\$86,000</u>	<u>\$124,000</u>	<u>\$296,000</u>
Share of earnings after consolidation . . .	29%	29%	42%	100%
Share of earnings before consolidation . . .	30	30	40	100

Cash and short-term obligations.—In all of the preceding cases it was assumed that the stockholders of the old companies became stockholders of the consolidated company; the problem of settlement therefore involved a distribution of securities in such a manner as to give the stockholders equitable interests in the assets and the earnings. If the old stockholders are bought out, and are paid immediately in cash, or partly in cash and partly in short-term obligations, their subsequent sharing of profits will be eliminated, and the settlement will be based on acceptable offers from the purchasers. However, the amounts to be paid should still be governed by the amounts of net assets and net earnings.

If the stockholders of the old companies wish to retain stock control of the consolidated company, but to obtain certain amounts of cash immediately, or in the near future, through the payment of short-term obligations issued by the consolidated company, or if certain assets are not to be transferred to the consolidated company, proper consideration should be given to the effect of such cash withdrawals or asset withholdings upon the net assets for which preferred stock is to be issued, and the effect upon the earnings taken as a basis for the allotment of common stock.

Modifications.—The procedures discussed and illustrated in the preceding pages are merely indicative of the principles to be borne in mind in effecting consolidations; they cannot be accepted as procedures to be invariably followed.

The general desirability of issuing both preferred and common stocks to the stockholders of the predecessor companies has been emphasized; however, if new funds are required, the old stockholders may have to accept common stock only, in order that the preferred stock may be reserved for issuance to the suppliers of new capital.

The general desirability of making the preferred stock issued to the old stockholders fully participating has been discussed; but the poor profit record of certain companies may make this provision in the preferred stock impracticable.

In the cases illustrated, the stockholders of all companies shared ratably in all classes of securities issued; but the stockholders of one or more companies may desire to withdraw from the management, leaving the control to others, and taking cash, bonds, or preferred stock for their interests.

These and other matters almost invariably require modifications in the methods described, but the illustrations serve to indicate the basic principles involved in safeguarding the stockholders of several consolidating companies in their interests in the assets and earnings of the consolidation.

Balance sheets giving effect to financing.—When securities are offered to the public in connection with a consolidation of several companies or otherwise, accountants are usually asked to prepare, for publication in the offering sheet, a balance sheet of the issuing company giving effect to the financing. To illustrate, assume that investment bankers have agreed to purchase, as of March 1, 1934, a company's bonds of a par value of \$100,000.00 at 95. The bankers, in preparing the offering sheet to be used in selling the bonds to the public, will wish to indicate the financial condition of the company after, rather than before, the financing. An accountant will probably be asked to apply the financing to his most recent audited balance sheet of the company, possibly that of December 31, 1933. Assuming that \$75,000.00 of the proceeds of the financing is to be used in liquidating notes payable, the accountant's working papers may be similar to those shown on page 405. The balance sheet giving effect to the financing

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(sometimes called a "pro forma balance sheet") will embody the figures in the last column of the working papers.

COMPANY A				
Working Papers for Balance Sheet Giving Effect to Financing				
As of December 31, 1933				
	Before Fi- nancing	FINANCING ADJUSTMENTS		After Fi- nancing
		Debit	Credit	
Assets				
Current Assets:				
Cash.....	4,000	95,000(a)	75,000(b)	24,000
Accounts Receivable.....	75,000			75,000
Inventory.....	125,000			125,000
Fixed Assets:				
Land and Buildings.....	150,000			150,000
Machinery and Equipment..	90,000			90,000
Deferred Charges:				
Unexpired Insurance	2,000			2,000
Bond Discount.....		5,000(a)		5,000
	<u>446,000</u>			<u>471,000</u>
Liabilities and Net Worth				
Current Liabilities:				
Accounts Payable.....	50,000			50,000
Notes Payable.....	75,000	75,000(b)		
Fixed Liabilities:				
6% Bonds Payable.....			100,000(a)	100,000
Net Worth:				
Capital Stock.....	250,000			250,000
Surplus.....	71,000			71,000
	<u>446,000</u>	<u>175,000</u>	<u>175,000</u>	<u>471,000</u>

Propriety of "giving effect" statements.—A "giving effect" balance sheet portrays a financial condition which never, in fact, exists, because the balance sheet at a stated date is adjusted to give effect to certain transactions which may have occurred at a subsequent date (such as a consummated issuance of securities), or to transactions which are only in prospect (such as the proposed purchase of securities by an investment banker in accordance with a contract, and the application of the proceeds as forecast by the management of the issuing company). Is an accountant justified in issuing and certifying to such a balance sheet?

It is usually regarded as permissible for him to do so if: (1) the period between the date of the balance sheet and the date of the financing transaction is not too great—possibly not in excess of three or four months; (2) no other transactions have, in the meantime, materially affected the company's

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financial condition; and (3) the financing transaction is definitely determinable and based on a contract between the issuing company and the security underwriters or investment bankers.

The heading of the "giving effect" balance sheet, and the appended certificate, should indicate the nature of the transactions to which effect has been given. For instance, the heading of the balance sheet might read somewhat as follows:

THE X Y COMPANY

Balance Sheet—December 31, 1934

Giving effect as of that date to the proposed issuance of \$1,000,000.00 of first mortgage bonds, and the application of the proceeds to the retirement of preferred stock and to an increase in working capital.

And the accompanying certificate might read somewhat as follows:

We have audited the accounts of The X Y Company as of December 31, 1934, and have examined a contract providing for the issuance of \$1,000,000.00 of first mortgage bonds.

We Hereby Certify that, in our opinion, the foregoing balance sheet fairly reflects the financial condition of the company on December 31, 1934, after giving effect as of that date to the proposed issuance of the above-described bonds, and to the application of the proceeds thereof in retiring preferred stock and increasing the working capital.

CHAPTER 52

FOREIGN EXCHANGE

Scope of discussion.—Foreign exchange is of interest and importance to:

Banks and brokers dealing in foreign exchange.

Business concerns exporting or importing merchandise, holding foreign investments, operating foreign branches or subsidiaries, or engaging in other activities involving receipts from, or remittances to, other countries.

The accounting problems and procedures of foreign-exchange brokers and of banks maintaining foreign-exchange departments constitute a specialized field to which a book dealing with the general field of accounting may properly give only incidental consideration.

At the time of writing these chapters (May 1934), foreign exchange is in a chaotic and somewhat uncertain condition. Most of the major countries of the world are "off the gold standard." Although their monetary systems are still actually or theoretically based on coins containing gold of a legally established weight and fineness, they have suspended their obligation to sell gold at the legal monetary par or to redeem their paper money in gold at par, or have placed embargoes or governmental limitations upon gold shipments. As a result of these and other conditions, current foreign exchange rates bear strange relationships to par.

Moreover, the United States has recently changed the gold content of its dollar. The gold dollar formerly contained 25.8 troy grains of metal, of which nine tenths was gold and one tenth was alloy introduced to harden the coin and give it durability; the pure gold content of the dollar was therefore nine tenths of 25.8 grains, or 23.22 grains. The present theoretical gold dollar, as established by the Presidential proclamation of January 31, 1934, contains $15\frac{5}{21}$ grains of metal, of which nine tenths is gold; the word "theoretical" is used because gold is no longer coined, and

paper money is not redeemable in gold. Moreover, at this writing, it appears that the situation may shortly be further complicated, as there seems to be some prospect of supporting the currency by reserves consisting of silver as well as gold.

Foreign money; par rates.—Coinages are based on actual or theoretical monetary units containing gold (or silver) of a legally established weight and fineness. For example:

	Total Grains	Fraction Fine	Gold Grains
United States dollar:			
Prior to January 31, 1934.	25.8	$\frac{9}{10}$	23.22
Established by Presidential pro- clamation of January 31, 1934	$15\frac{5}{21}$	$\frac{9}{10}$	13.7143
British pound sterling.	123.274	$1\frac{1}{12}$	113.0011

Mint par rates applicable to the coins of two countries, both of which are based on gold, are computed by determining the relative amounts of pure gold in the two coins. The par rate for the pound on the old basis was determined thus:

$$\frac{113.0011}{23.22} = 4.8665$$

The par rate on the new basis is determined as follows:

$$\frac{113.0011}{13.7143} = 8.2397$$

So long as there is no change in the metallic content of the coins of two countries which are both on a gold basis, the mint par rates applicable to their coins will not change. But when the gold content of either coin changes, the par rate changes. For example, the reduction of the gold content of the French franc under the stabilization law of 1928 reduced the par rate for the franc from \$.1930 to \$.0392; and the reduction of the gold content of the dollar in January 1934 increased the par rate of the franc to \$.0663.

If the coin of one country is based on gold, and the coin of another on silver, the mint par rate will fluctuate with changes in the price of silver in terms of gold. The Hong Kong dollar, for instance, contains 416 grains of silver, nine tenths fine, or 374.4 grains of pure silver. To determine the mint par rate applicable to the Hong Kong dollar in terms of the United States dollar at any date, it is necessary to determine the market value, in United States dollars,

of 374.4 grains of silver.

The following table shows the par values of the coins of various countries, as estimated by the Director of the Mint and proclaimed by the Secretary of the Treasury, as of October 1, 1933, and April 1, 1934.

Country	Legal Standard	Monetary Unit	VALUE IN TERMS OF U. S. MONEY	
			October 1, 1933	April 1, 1934
Argentine Republic	Gold	Peso	\$0.9648	\$1.6335
Austria	Gold	Schilling	.1407	.2382
Belgium	Gold	Belga	.1390	.2354
Bolivia	Gold	Boliviano	.3650	.6180
Brazil	Gold	Milreis	.5462	.2025
British Colonies in Australasia and Africa	Gold	Pound Sterling	4.8665	8.2397
British Honduras	Gold	Dollar	1.0000	1.6931
Bulgaria	Gold	Lev	.0072	.0122
Canada	Gold	Dollar	1.0000	1.6931
Chile	Gold	Peso	.1217	.2060
China	Silver (Stated values are estimated market values, in gold, of sil- ver content of units.)	Yuan, prior to March 1933	.2894	.3491
		Yuan, established March 3, 1933	.2844	.3432
		Dollar { Hong Kong British Mexican	.2937	.3544
Colombia	Gold	Peso	.9733	1.6480
Costa Rica	Gold	Colon	.4653	0.7879
Cuba	Gold	Peso	1.0000	1.6931
Czechoslovakia	Gold	Krone	.0296	.0502
Denmark	Gold	Krone	.2680	.4537
Dominican Republic	Gold	Dollar	1.0000	1.6931
Ecuador	Gold	Sucre	.2000	.3386
Egypt	Gold	Pound (100 piasters)	4.9431	8.3692
Estonia	Gold	Kroon	.2680	.4537
Finland	Gold	Markka	.0252	.0426
France	Gold	Franc	.0392	.0663
Germany	Gold	Reichsmark	.2382	.4033
Great Britain	Gold	Pound Sterling	4.8665	8.2397
Greece	Gold	Drachma	.0130	.0220
Guatemala	Gold	Quetzal	1.0000	1.6931
Haiti	Gold	Gourde	.2000	.2000
Honduras	Gold	Lempira	.5000	.8466
Hungary	Gold	Pengő	.1749	.2961
India (British)	Gold	Rupee	.3650	.6180
Indo-China	Gold	Piaster	.3918	.6633
Italy	Gold	Lira	.0526	.0891
Japan	Gold	Yen	.4985	.8440

Country	Legal Standard	Monetary Unit	VALUE IN TERMS OF U. S. MONEY	
			October	April
			1, 1933	1, 1934
Latvia	Gold	Lat	.1930	.3267
Liberia	Gold	Dollar	1.0000	1.6931
Lithuania	Gold	Litas	.1000	.1693
Mexico	Gold	Peso	.4985	.8440
Netherlands and colonies	Gold	Guilder (Florin)	.4020	.6806
Newfoundland	Gold	Dollar	1.0000	1.6931
Nicaragua	Gold	Cordoba	1.0000	1.6933
Norway	Gold	Krone	.2680	.4537
Panama	Gold	Balboa	1.0000	1.6933
Paraguay	Gold	Peso (Argentine)	.9648	1.6335
Persia	Gold	Rial	.0487	.0824
Peru	Gold	Sol	.2800	.4740
Philippine Islands	Gold	Peso	.5000	.8466
Poland	Gold	Zloty	.1122	.1899
Portugal	Gold	Escudo	.0442	.0748
Roumania	Gold	Leu	.0060	.0101
Salvador	Gold	Colon	.5000	.8466
Siam	Gold	Baht (Tical)	.4424	.7491
Spain	Gold	Peseta	.1930	.3267
Straits Settlements	Gold	Dollar	.5678	.9613
Sweden	Gold	Krona	.2680	.4537
Switzerland	Gold	Franc	.1930	.3267
Turkey	Gold	Piaster	.0440	.0744
Union of Soviet Re- publics	Gold	Chervonetz		8.7123
Russia	Gold	Ruble	.5146	
Uruguay	Gold	Peso	1.0342	1.7511
Venezuela	Gold	Bolivar	.1930	.3267
Yugoslavia	Gold	Dinar	.0176	.0298

Conversions at par.—There are two types of conversion problems. Two illustrations of each type are given below, using par rates for conversion purposes.

(1) Converting a foreign value into a domestic value:

Problem: Convert £1,200 8s. 6d. to dollars.

Solution: Reduce shillings and pence to decimals of a pound, and multiply by the dollar value per pound.

Pounds.....	1,200.000
Shillings: 8s = $\frac{8}{20}$ of a pound.....	.400
Pence: 6d = $\frac{1}{2}$ of $\frac{1}{20}$ of a pound.....	.025
Total.....	1,200.425
Multiply by.....	\$8.2397
Dollar value.....	<u>\$ 9,891.14</u>

Problem: Convert fr.5,000 to dollars.

Solution: Multiply the number of francs by the dollar value per franc.

Francs	5,000
Multiply by.....	\$.0663
Dollar value.....	<u>\$331.50</u>

(2) Converting a domestic value to a foreign value.

Problem: Convert \$2,000.00 to pounds.

Solution: Divide the number of dollars by the dollar value per pound, and reduce fractions of a pound to shillings and pence.

$$\begin{aligned} 2,000.00 \div 8.2397 &= \text{£}242 \text{ } 727 \\ &= \text{£}242 \text{ } 14. \text{ } 546\text{s.} \\ &= \text{£}242 \text{ } 14\text{s. } 6\text{d.} \end{aligned}$$

Problem: Convert \$2,000.00 to francs.

Solution: Divide the number of dollars by the dollar value per franc.

$$2,000.00 \div .0663 = \text{fr.}30,165.91$$

Current rates.—Current exchange rates for cable transfers, drafts, and so forth may be quoted directly or indirectly.

Direct quotations are stated in the domestic currency.

All quotations are now made on this basis in the United States. The rates state the value of the foreign unit in cents (or dollars); for example, the following rates are stated in cents:

For pounds: 510.875
For francs: 6.61

Paris quotes pounds and dollars directly; the rates state the value of the foreign unit in francs; thus, for example:

For pounds: 77.29
For dollars: 15.129

Indirect quotations are stated in the foreign currency.

London quotes francs and dollars indirectly; that is, in terms of francs and dollars per pound; thus, for example:

For francs: 77.29
For dollars: 5.10875

The relation between direct and indirect quotations may be made clearer by the following summary:

<u>Between</u>	<u>QUOTATIONS BY</u>		
	<u>New York (Direct)</u>	<u>London (Indirect)</u>	<u>Paris (Direct)</u>
New York and London.	510.875	5.10875	
New York and Paris.	6.61		15.129
London and Paris.		77.29	77.29

Current rates differ according to the nature of the exchange; that is, rates for cable transfers are higher than those for checks, and rates for checks are higher than those for time drafts. For simplicity of presentation, however, we shall give only minor consideration to these differences in the following discussion.

Triangular parity; arbitrage.—A close relationship will always exist among the rates quoted in three or more countries for exchange among those countries. For instance, if London quotes dollars at 5.10875 and francs at 77.29, the rates for pounds quoted by New York and Paris will be extremely close to 510.875 and 77.29, respectively.

Moreover, the rate quoted by New York for francs will be close to 6.61 ($510.875 \div 77.29$), and the rate quoted by Paris for dollars will be close to 15.129 ($77.29 \div 5.10875$). To understand why this is so, assume that London quoted dollars at 5.10875 and francs at 77.29 as above, but Paris quoted dollars at 14.75. Dealers in exchange would immediately begin to take profits on arbitrage transactions. For instance, because of the low cost of dollars in Paris, a London banker might:

With £25,000 buy ($25,000 \times 77.29$) fr.1,932,250
 With fr.1,932,250 buy ($1,932,250 \div 14.75$) \$131,000
 With \$131,000 buy ($131,000 \div 5.10875$) £25,642,

thus making an arbitrage profit of £642. But the demand in Paris for dollars caused by such transactions would quickly raise the rate from 14.75 toward its triangular parity of 15.129.

Fluctuations in current rates.—The following table shows the par rates of five foreign currencies, and current rates prevailing in New York on three stated dates:

	BEFORE REDUCTION OF GOLD CONTENT OF U. S. DOLLAR				AFTER REDUC- TION OF GOLD CONTENT OF U. S. DOLLAR	
	Par Rate	Current Rates			Par Rate	Current Rate
		June 20, 1928	Dec. 31, 1932	Dec. 12, 1933		May 18, 1934
Pounds —Great Britain..	486.65	487.50	339.75	510.00	823.97	510.87
Francs —France.	3 92	3.93	3.93	6.10	6.63	6.61
Lire —Italy.	5 26	5.25	5.10	8.20	8.91	8.52
Marks —Germany	23 82	23 88	23.88	23.79	40.33	39.50
Guilders—Holland.	40.20	40.31	40.10	62.80	68.06	67.90

This tabulation of rates suggests several questions. In the first place, what causes the current rates to fluctuate so far from par; for instance, with the par of the pound on the old basis of 486.65, why should the current rate drop as low as 339.75 and rise as high as 510.00? In the second place, why did the change in the par rates not cause a much greater change in the current rates; for instance, why should the current rate for the pound have risen so little between December 12, 1933, and May 18, 1934, although, in the meantime, the par rose from 486.65 to 823.97?

The answer to these questions lies in the following facts: First, the par rates and the current rates apply to two entirely different things:

Par rates measure the relative quantities of pure gold in foreign and domestic coins (or the value of the silver in the coin of a country on a silver basis).

Current rates measure the values of intangible rights or claims.

Second, the rights or claims to which current rates are applicable are commodities whose value is determined by supply and demand.

It will therefore be desirable to give some consideration to the nature of these rights or claims, their origin, and the methods used in their settlement.

Intercountry debts and claims.—Foreign exchange procedure is a method of effecting settlements between debtors and creditors in different countries, and current rates of foreign exchange are affected by the amounts of intercountry

debts and claims that must be settled currently. Some of the most important sources of currently collectible inter-country claims are mentioned below:

- (1) Exports and imports of merchandise.
- (2) Purchases, sales, and flotations of securities in foreign countries. Such transactions create currently collectible claims against the purchasers of the securities. At the same time, of course, inter-country claims are created against the foreign issuers of the securities, but these are not currently due and collectible, and hence do not affect the current exchange rates.
- (3) Interest and dividends on intercountry holdings of securities.
- (4) Matured bonds and other long-term obligations held abroad, or periodical sinking fund deposits required to be made abroad.
- (5) Expenditures of tourists.
- (6) Short-term intercountry loans. Because of the frequent differences in interest rates in different countries, short-term loans are continually being made in, and repaid from, foreign countries.
- (7) Services, such as ocean shipping, insurance, and international banking.
- (8) Current installments payable on the intergovernmental debts which arose during and immediately after the World War.
- (9) Short-term loans made by one government to another.
- (10) Current installments payable on reparations.

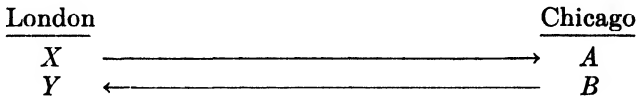
A country is said to enjoy a favorable balance if its claims receivable exceed its claims payable. Its balance is unfavorable if its claims payable exceed its claims receivable.

Settlements by exchange of claims.—It is not customary, except in infrequent instances, to liquidate foreign debts by the actual shipment of gold. Such a procedure would be too expensive. Instead, intercountry debts are settled by a system which is virtually an exchange of claims and is known as foreign exchange. Using, for the time being, the present

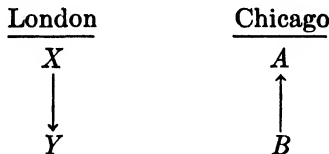
par value of the pound, 823.97, let us suppose that:

- X, a London importer, buys goods from A, a Chicago manufacturer, for \$8,239.70, and that
- Y, a London manufacturer, sells goods to B, a Chicago importer, for £1,000.

If these two claims were settled by actual shipments of gold, the shipments would be made as follows:



But such a procedure would involve two expensive shipments of equal amounts of gold. If the necessary arrangements could be made by the four parties, the two debts, since they are of equal amounts, might be settled by an exchange of claims and by payments in London and Chicago as follows:



Y receives his money from X instead of from B; and A receives his money from B instead of from X. But such a method of settlement would be virtually impossible if X and Y, in London, and A and B, in Chicago, were obliged to find each other and personally arrange the exchange of claims. To simplify the exchange procedure, the claims are put into the form of bills of exchange and other commercial paper, and foreign exchange brokers and bankers serve as a clearing house for the exchange of these claims.

To illustrate how the two claims might be settled by customary foreign exchange procedures (ignoring, for the time being, the difference between par and current rates and the bankers' profits), let us assume the following chain of events:

A, in Chicago, who has a claim of \$8,239.70 against X, in London, draws a sight draft for that amount on X and sells it to a

Chicago bank. (*A* has now received the money for his goods.)

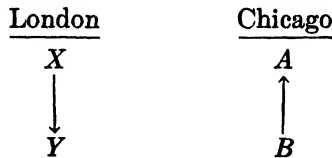
The Chicago bank sends the draft to a London bank for collection; the London bank collects from *X* its sterling equivalent, £1,000, and credits this amount to the Chicago bank.

B, in Chicago, who wishes to pay £1,000 to *Y*, in London, buys from the Chicago bank a £1,000 draft drawn by the Chicago bank against its London deposit, and mails this draft to *Y*. (*B* has now paid his indebtedness.)

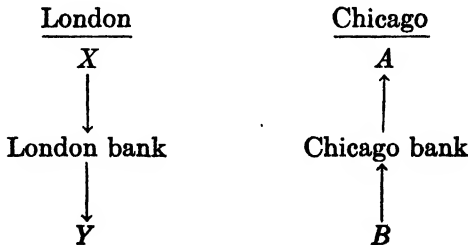
X, in London, pays his debt to *A* when he pays the London bank the amount of *A*'s sight draft.

Y, in London, collects the amount of his claim against *B* when he collects from the London bank the draft drawn on it by the Chicago bank.

By this series of transactions, the Chicago bank receives \$8,239.70 from *B* and pays it to *A*; and the London bank receives £1,000 from *X* and pays it to *Y*. Thus, instead of the theoretically possible, but practically impossible, offsets represented by the preceding diagram:



we find a perfectly practicable method of effecting offsets, as represented by the following diagram:



In this illustration it was assumed that the two inter-country claims were equal in amount. One of the essential features of the service of the foreign exchange bankers is their

willingness to buy good commercial paper of any amount from any responsible holder, and to sell their own drafts in any amount. It was also assumed that the settlement was effected by the use of a sight draft and a banker's draft. Other forms of exchange may be used.

Cable transfers.—A cable transfer is an order, transmitted by cable, usually upon a bank, to pay a certain sum of money to a designated beneficiary. In a sense, therefore, a cable transfer is a draft. Thus, if *D* in New York must remit £1,000 to *E* in London, *D* may purchase a draft drawn by a New York bank on its London correspondent and mail this draft to *E*; or *D* may purchase from his bank a cable transfer which will order the London bank to pay £1,000 to *E*. The effect of the two methods is identical except for the time required to make the payment and the somewhat higher price which will probably be charged by the bank for the cable transfer.

Bills of exchange.—A bill of exchange is an unconditional order in writing, addressed by one person to another, to pay to a designated person or to his order, a sum certain in money on demand or at a fixed or determinable future time. Bills of exchange may be classified as:

Banker's bills, drawn by a bank or banker upon another bank or banker; such bills, as used in foreign exchange, are comparable to the bank drafts used in domestic exchange.

Commercial bills, drawn by a merchant on another merchant or a bank, or drawn by a bank on a merchant.

Bills of exchange may be classified according to the time when payment is ordered, as follows:

Sight bills, payable upon presentation.

Time bills, which may be further classified as:

Short bills, drawn for less than thirty days after sight.

Long bills, drawn for thirty or more days after sight.

Bills of exchange may also be classified with respect to any attached security, as follows:

Clean bills, drawn against deposits or previously arranged credits, and without any documents or collateral attached.

Secured or documentary bills, to which are attached documents serving as collateral to the bills.

For instance, if an American has sold stocks or bonds to a foreign purchaser, the securities sold may be attached to a bill drawn on the purchaser; the securities serve as collateral to the bill until it is paid or accepted by the foreign purchaser, when they are detached and delivered to him. If the bill is drawn for collection of a debt arising from a sale of merchandise, the attached documents will include a bill of lading, consular invoice, seller's invoice, insurance certificate, and so forth.

Secured or documentary bills may be further classified according to the requirements for the release of the documents, as follows:

Documentary acceptance bills: The documents accompanying such a bill are released to the drawee immediately upon his acceptance of the bill, which thereupon becomes a clean bill.

Documentary payment bills: The documents accompanying such a bill are not released to the drawee until the bill is paid.

Letters of credit.—A letter of credit is an instrument addressed by the issuing bank to all or some of its foreign correspondents, introducing the holder, certifying that he is authorized to draw a stated aggregate sum of money, and requesting that his drafts be honored up to that amount. It is used by travelers for the payment of expenses and sometimes for the financing of purchases. To obtain funds, the holder of such a letter presents it and the accompanying letter of identification to a named correspondent bank, and draws a draft against the letter. The paying bank indorses the amount of the draft on the letter, to show how much of the credit has been utilized, and sends the draft to the issuing bank for credit. The issuing bank may receive its payment for the letter of credit either at the time of its issuance or after the payment of the drafts drawn against it.

How debts are paid.—Now that we are familiar with some of the documents used in foreign exchange, let us assume that *N*, a New York exporter, sells goods to *L*, a London importer, and consider some of the ways by which the debt may be paid by *L* to *N*. Payment by *L* in dollars from the proceeds of a letter of credit requires no consideration; so far as *N* is concerned, the transaction does not differ from a sale to a domestic customer.

N will usually bill in dollars, to eliminate risks arising from exchange fluctuations. If he bills in pounds, he may bill at the pound equivalent of his dollar price at the rate current at the date of billing. A rise or fall in the exchange rate between the date of billing and the date of settlement will mean a gain or a loss to *N*, unless he hedges by the method described under the subsequent caption "Futures."

For purposes of the following illustrations we shall use the current rate as of May 18, 1934, or 510.87, and shall assume that, in the illustrations based on dollar billing, the goods were billed at \$5,108.70, and that, in the illustrations based on pound billing, the goods were billed at £1,000.

(I) Goods billed in dollars and documents drawn in dollars:

- (1) *L* may make the payment by purchasing from his London bank a cable transfer for \$5,108.70, payable to *N*.
- (2) *L* may perhaps maintain a deposit in a New York bank, and thus be in a position to send *N* his personal check on the New York bank, drawn in dollars. This procedure would be unusual, except perhaps in the case of very large importers.
- (3) *L* may obtain and send to *N* a draft for \$5,108.70, drawn by a London bank against its New York correspondent.
- (4) *L* may have established a credit arrangement with a New York bank which will pay sight drafts or accept time drafts drawn against it. *N* may then draw a draft for \$5,108.70 on the New York bank, attach the shipping documents thereto, and present the draft to the New York bank for:
 - (a) Payment, if it is a sight draft; in this case *N* will obtain the \$5,108.70 immediately.

- (b) Acceptance, if it is a time draft; in this case *N* cannot obtain the entire \$5,108.70 immediately, but can obtain only the proceeds by selling the draft at a net price after deducting the discount to maturity.

(II) *Goods billed in pounds and documents drawn in pounds:*

- (5) *L* may send *N* his personal check for £1,000 against his London bank.
- (6) *L* may send a draft drawn by a London bank against a London bank.

By methods 5 and 6, *N* will receive a check or draft for £1,000, which he will present to his New York bank, and for which he will receive the dollar equivalent computed at the current exchange rate. The New York bank will forward the check or draft to its London correspondent for credit.

- (7) *L* may have established a credit arrangement with a London bank by which that bank will pay sight drafts or accept time drafts drawn against it. *N* may then draw a draft on this London bank for £1,000, attach the shipping documents thereto, sell the draft to a New York bank, and receive the proceeds computed at the current exchange rate. The New York bank will send the draft and the attached documents to its London correspondent.

In London, the draft will be presented to the drawee bank for:

- (a) Payment, if it is a sight draft.
- (b) Acceptance, if it is a time draft.
- (8) *N* may draw on *L* a sight draft or a time draft for £1,000, attach the shipping documents thereto, and sell the draft to his New York bank for its dollar value at the current rate. The New York bank will send the draft to its London correspondent.

In London, the draft will be presented to *L* for:

- (a) Payment, if it is a sight draft.
- (b) Acceptance, if it is a time draft.

Relative desirability of methods.—Which of the methods described in the foregoing section will the New York exporter

of merchandise prefer? Naturally, he will prefer the methods by which he will obtain his money:

(A) Without danger of loss from fluctuations in exchange rates.

For this reason he will prefer methods 1, 2, 3, and 4, in which billings are made in dollars, and the hazards of exchange loss are thrown upon the foreign purchaser.

(B) Immediately upon shipment of the merchandise.

For this reason he will prefer method 4, in which he draws a draft on a New York bank. He *may* receive his money promptly by methods 1, 2, and 3, but that will depend upon the promptness of the foreign importer in making his remittance.

(C) Without loss of discount.

For this reason he will prefer method 4a (sight draft) to method 4b (time draft).

It is evident, therefore, that the method of settlement most satisfactory to the New York exporter, and the one which will probably induce him to quote the best price for his merchandise, is the method (4a) under which he draws a dollar sight draft, at the date of shipment, on a New York banker against a credit arranged by the foreign purchaser.

Discount on time drafts.—Let us return to the illustration in which *N*, in New York, drew a time bill on *L* in London, or on a bank in London which stood ready to accept the bill for *L*'s account, and consider the subsequent history of the bill and the factors which will determine the amount of discount that *N* will be obliged to suffer in disposing of it.

The New York bank, after purchasing the bill, will send it to a London bank, which will obtain acceptance from *L* or *L*'s bank, and will discount the bill and credit the New York bank with the proceeds. In a money market such as London, there are always enormous quantities of liquid bank capital seeking investment in such paper by purchasing it at its discounted value. The ultimate holder of the acceptance, which may be discounted and rediscounted several times before its maturity, will present it to the drawee (*L* or *L*'s bank) at maturity for payment.

The amount that *N* will receive from the New York bank which purchases the draft will depend upon the amount of discount which the New York bank expects will be suffered upon the sale of the draft in London. What factors will determine the amount of this discount?

- (1) The discount rate prevailing in the London discount market, which, in turn, will be affected by the rediscount rate quoted by the Bank of England.
- (2) The quality of the paper, as determined by the credit standing of the drawer and the drawee. The New York bank will be obliged to indorse the draft when it transfers the paper to its London correspondent; the London bank's indorsement will be required when the draft is resold in the open discount market; both banks will thus incur contingent liabilities which will continue until the maturity of the paper. Obviously, a higher price will be paid for prime paper than for paper which may not be collected. For this reason, *N* will prefer a draft drawn on *L*'s bank to a draft drawn on *L*.
- (3) The possibility of any serious financial disturbance in the market where the bill is payable, which may interfere with the prompt payment of the bill at maturity.
- (4) The usance of the bill, or the time it is to run. This factor, of course, would affect the amount of discount even if there were no risk involved; but it also affects the risk, for the longer the period during which the fate of the bill will be unknown, the greater the risk undertaken as an incident to the indorsement, and the greater the spread which the purchaser of the bill will demand for incurring the risk.

Fluctuations in current exchange rates.—Current exchange rates vary from day to day as the result of changes in the supply of and demand for foreign bills. To understand why this is so, let us put ourselves in the position of a New York foreign exchange banker with a correspondent in London. We buy drafts and other forms of exchange payable in pounds, and send them to our correspondent for credit;

against this credit we sell drafts or other forms of exchange payable in pounds. We are dealing in a commodity called pounds, and our account with our foreign correspondent becomes the storehouse for this commodity. The supply of the commodity is furnished by those who hold receivables collectible in pounds; the demand is created by those who owe debts which must be paid in pounds. If the supply is greater than the demand, the price will be low, or below par. If the demand is greater than the supply, the price will be high, or above par.

The demand for and the supply of foreign exchange between two countries are affected by the relative volumes of intercountry transactions such as those mentioned earlier in the chapter under the caption "Intercountry debts and claims." They are also affected by transactions involving debtors and creditors in other countries. For instance, an American exporter, shipping goods to China, may be paid by a draft on a London bank. Or a French banker with a larger dollar balance in New York than he desires, and with a smaller pound balance in London than he desires, may use his dollar balance to buy pounds in New York and direct that they be transferred to his London correspondent, to increase his pound balance in London.

Reciprocal nature of exchange rates.—Let us assume that, for some reason, the requirements for transfers of funds from London to New York exceed the requirements for transfers of funds from New York to London.

In New York:

The supply of exchange (transfers from London) will exceed the demand (transfers from New York); exchange on London will be quoted in New York at less than par—say at 510.87.

In London:

The demand for exchange (transfers from London) will exceed the supply (transfers from New York); exchange on New York will be quoted in London at more than par—probably at or very close to 5.1087.

But how can a change from par (8.2397) to 5.1087 represent a fall in the price of exchange in New York and a rise in

the price of exchange in London? The answer is: 510.87 is a direct quotation in New York and an indirect quotation in London. In New York a pound draft can be purchased for \$5.1087 instead of for \$8.2397; clearly London exchange is at a discount in New York. In London £1 will not buy a draft for \$8.2397; it will buy only \$5.1087; from the London viewpoint, exchange is at a premium.

Gold or specie points.—If no governmental restriction exists with respect to the shipment of gold, exchange rates will not usually rise or fall beyond certain levels known as the gold or specie points. These points vary from time to time, and of course are affected by any change in the par rate; they are determined by the cost of exporting and importing gold, which includes freight, marine insurance, assay office charges if the gold is shipped in bars, abrasion if the gold is shipped in coins, and loss of interest. The gold points are immediately abolished, however, by a governmental prohibition upon the shipment of gold.

“Off the gold standard.”—A country is on the gold standard so long as its government stands ready to redeem all of its obligations in gold, upon demand and without restriction. It is off the gold standard as soon as such redemption is discontinued.

To keep itself in a position to redeem its notes in gold on demand, a government must maintain adequate gold reserves; but its reserves may be depleted if subjected to the drain of gold exportations resulting from unfavorable exchange rates, or to the drain created by domestic hoarders of gold. When a government faces a dangerous depletion of its gold reserves, it may place a restriction on gold exports, while continuing the redemption of its notes in gold; from a domestic standpoint it may still be regarded as on the gold standard, but it is off the gold standard from an international standpoint. If it also ceases the gold redemption of all its domestic obligations, it is completely off the gold standard.

What happens to exchange rates when a country goes off the gold standard? Embargoes upon the exportation or importation of gold between two countries abolish the gold points, and thus permit unlimited rises or falls in the

exchange rates. In this connection it will be interesting to note the quotations for pounds at three dates, as shown on page 413.

June 20, 1928.	487.50
Dec. 31, 1932.	339.75
Dec. 12, 1933.	510.00

On June 20, 1928, Great Britain and the United States were both on the gold standard, and the rate was within the gold points. On December 31, 1932, Great Britain was off the gold standard, gold could not be imported from Great Britain, the import gold point (approximately 482.75) was inoperative, and the rate fell to 339.75. On December 12, 1933, the United States was also off the gold standard, gold could not be exported, the export gold point (approximately 489.05) was no longer operative, and the rate rose to 510.00.

Thus it appears that, after the gold points have been abolished by embargoes on the export or import of gold, the supply of and demand for drafts and other forms of exchange exercise an unrestricted influence on the current rates. But other influences may also affect the rates. After a country prohibits the exportation of gold, drafts drawn on debtors in that country are, in the last analysis, payable in paper money; if the country issues large quantities of non-convertible paper money (as Germany and France did after the War), its paper money will depreciate, and drafts payable in such currency will correspondingly depreciate; in other words, exchange rates on such a country will fall.

After a country has gone off the gold standard, its government may undertake, by various methods, to maintain some stability in its exchange rates. Any tendency of rates to rise, because the demand for exchange (to pay for imports and so forth) exceeds the supply (obtained in collection for exports and so forth), may be curbed by placing quota limitations on imports, and by stimulating exports. Or the purchase and sale of drafts and other forms of exchange may be taken out of the hands of the ordinary commercial agencies and placed under governmental control, so that competitive prices may be eliminated and fixed prices established. Or the available supply of exchange may be rationed; this will tend to restrict importations, because a prospective importer is not

likely to make commitments unless he knows in advance that he will be able to obtain the necessary exchange to make the payment. Or accounts may be "blocked," which means that foreign bankers and others are not able to draw upon their balances.

But a rise in exchange rates tends to stimulate exports, and thus automatically to reduce the rates by increasing the supply of exchange. How does a rise in the exchange rates stimulate exports? Let us place ourselves in the position of an American manufacturer attempting to compete with a British manufacturer for export business. Our British competitor quotes an article for £100; a similar quotation by us on December 31, 1932, would have netted us \$339.75. A quotation of £100 on December 12, 1933, when we were off the gold standard, would have netted us \$510.00. Assume that we must have \$400.00 to make a profit on our merchandise. On December 31, 1932, we could not have met the competition. On December 12, 1933, we could have quoted approximately £80. Going off the gold standard put us in a better position to meet world competition for foreign trade. To the extent that a country's exports are thus increased, its supply of exchange on other countries is increased; and the increase in the supply of exchange tends to reduce the rates.

The rise in exchange rates resulting from going off the gold standard is not, however, wholly advantageous. While exporters may benefit, importers suffer. Moreover, the general condition of instability is undesirable.

Futures.—In the discussion of the various methods of making intercountry payments, it was noted that each party to an intercountry transaction will usually prefer to have the billing in his own currency, since the hazard of exchange fluctuations will thus be thrown upon the other party to the transaction. If billings are made in the foreign currency, purchases or sales of futures, or forward exchange, may be made as an insurance against fluctuations in the exchange rate.

For example, a New York exporter sells goods billed at £1,000, due sixty days hence; he does not know what rate will prevail when he receives the draft, and consequently he does not know whether he will make a profit or suffer a loss on the fluctuation in the exchange rate during the sixty days.

But he can eliminate the chance of profit or the hazard of loss by selling £1,000 due sixty days hence; or, in other words, by contracting to deliver £1,000 in sixty days at a price now determined. This sale of a future, in effect, establishes the dollar value of the £1,000 draft which he is entitled to receive from his debtor at the expiration of the credit period.

On the other hand, a New York importer who purchases goods billed at £1,000, payable in sixty days, can eliminate the element of speculative profit or loss on exchange rate fluctuations by immediately purchasing £1,000 deliverable to him at the end of sixty days, when he will need the exchange for the payment of the imported merchandise.

Conversions at current rates.—The arithmetical procedure for making conversions at current rates does not differ from that discussed under the preceding caption of “Conversions at par.” To illustrate:

Problem: What will be the cost of a draft for £15,000 at 5.10?

Solution: $\$5.10 \times 15,000 = \$76,500.00$, the cost in dollars.

Problem: How many pounds can be purchased for \$25,000.00 at a rate of 5.10?

Solution: $25,000 \div 5.10 = 4,901.96$ pounds obtainable
= £4,901 19s. 2d.

Interest on foreign money.—While short methods are available for those who are thoroughly familiar with foreign coinage, it is hardly worth while to learn these short methods if interest computations are to be made only occasionally. Two methods are available, both of which are illustrated by the following example:

What is the interest on £310 10s. 6d. for 90 days at 6%?

First solution: Reduce the shillings and pence to decimals of a pound.

Compute the interest in pounds and decimals.

Reduce the result to pounds, shillings, and pence.

FOREIGN EXCHANGE

Pounds.....	£310.000
Shillings: 10s. = ½ pound.....	.500
Pence: 6d. = ½ of ½ of a pound..	.025
Total.....	<u>£310.525</u>
Interest for 60 days (point off two places).....	£ 3.10525
Int. for 30 days (one half thereof)...	<u>1.552625</u>
Interest for 90 days.....	<u>£ 4.657875</u>
20 (shillings per pound) x .657875 = 13.1575, number of shillings.	
12 (pence per shilling) x .1575 = 1.89, number of pence.	
Interest = £4 13s. 2d.	

Second solution: Reduce pounds and shillings to pence.
 Compute the interest in terms of pence.
 Reduce to pounds, shillings, and pence.

Number of pounds.....	310
Multiply by number of shillings per pound	<u>20</u>
Pounds reduced to shillings.....	6,200
Add shillings.....	10
Total.....	<u>6,210</u>
Multiply by number of pence per shilling..	<u>12</u>
Pounds and shillings reduced to pence....	74,520
Add pence.....	<u>6</u>
Total pence.....	<u>74,526</u>
Interest for 60 days.....	745.26d.
Interest for 30 days.....	372.63d.
Interest for 90 days.....	<u>1,117.89d.</u>
1,118 ÷ 12 = 93, with a remainder of 2, or 93 shillings, 2 pence.	
93 ÷ 20 = 4, with a remainder of 13, or 4 pounds, 13 shillings.	
Total interest = £4 13s. 2d.	

Bank's accounts with foreign correspondents.—A bank's accounts with its foreign correspondents are of two classes:

Vostro accounts, or accounts due to foreign banks and bankers.

These accounts show the dollar balances maintained by foreign banks and bankers. They are credited with deposits received in dollars, and are charged with dollar drafts, and so forth, drawn by the foreign depositors against these deposits.

Nostro accounts, or accounts due from foreign banks and bankers.

These accounts show the pound, franc, or other balances maintained *with* foreign banks and bankers. They are charged with deposits made with foreign correspondents, and are credited with items payable out of these deposits.

To illustrate the use of these accounts, assume that the *L* Bank of London and the *N* Bank of New York are correspondents.

All exchange transactions conducted between the two banks in dollars will be recorded in the:

Vostro ledger of the New York bank, in an account with *L* Bank—London, and in the Nostro ledger of the London bank, in a reciprocal account with *N* Bank—New York.

All exchange transactions conducted between the two banks in pounds will be recorded in the:

Vostro ledger of the London bank, in an account with *N* Bank—New York, and in the Nostro ledger of the New York bank, in a reciprocal account with *L* Bank—London.

The vostro accounts are kept in the domestic currency only, and are similar to the accounts of domestic depositors.

The nostro accounts are kept in both currencies, but the foreign currency columns are merely memorandum columns like the quantity columns in a perpetual inventory account. The general procedure of keeping the nostro accounts and the method of closing them to determine the profit or loss, may be illustrated by the following account. The debits for drafts and other forms of pound exchange purchased and sent abroad for deposit, and the credits for drafts and other forms of pound exchange sold, are condensed into one entry each, for simplicity.

		Name of Foreign Bank			
		£	\$	£	\$
Purchases.....	5,000-0-0	25,450.00	Sales.....	3,000-0-0	15,360.00
Exchange.....		110.00	Balance.....	2,000-0-0	10,200.00
	<u>5,000-0-0</u>	<u>25,560.00</u>		<u>5,000-0-0</u>	<u>25,560.00</u>
Balance down..	2,000-0-0	10,200.00			

The account shows total purchases of £5,000 at a total cost of \$25,450.00, and total sales of £3,000 for \$15,360.00. The profit or loss on the foreign exchange trading may be computed daily or less frequently. To determine the profit or loss, the balance (£2,000) shown by the foreign amount columns is computed and entered in the foreign amount column. The foreign balance is then converted into dollars, at the rate current at the close of the day's business, and the dollar balance (\$10,200.00) thus ascertained is entered in the dollar amount column. In the illustration, the £2,000 balance was converted at 5.10. After these figures are entered in the proper columns, the foreign amount columns balance, but the dollar amount columns do not balance. To balance the dollar columns, a journal entry is made in dollars, debiting the account and crediting Exchange for the profit (\$110.00) shown by the account, or crediting the account and debiting Exchange for the loss.

CHAPTER 53

FOREIGN EXCHANGE (Continued)

Foreign purchases.—An American importer, buying goods abroad, may be billed in dollars or in the foreign currency. If the American importer is billed in dollars, the foreign exporter will make the gain or bear the loss resulting from any fluctuation in exchange rates between the date of purchase and the date of settlement. For if an American importer purchases goods billed to him at \$1,000.00, no fluctuation in exchange can cause him to remit more or less than \$1,000.00 in settlement; any fluctuations in exchange rates will affect the amount of foreign money which the exporter will obtain for the \$1,000.00 draft.

But if the importer is billed in terms of foreign currency, the fluctuations in exchange rates will affect the settlement. To illustrate, assume that a Chicago merchant purchases an invoice of goods billed to him at £1,000. The rate at the date of purchase is 5.12. The entry for the purchase will be:

Purchases	\$5,120.00	
London Manufacturer		\$5,120.00

When the entry is posted to the London manufacturer's account, a notation will have to be made of the amount of the bill in pounds, or the account may be kept with pound and dollar columns on both sides.

If, at the date of settlement, the rate is 5.10, a draft for £1,000 will cost \$5,100.00, and the entry to record the settlement will be:

London Manufacturer	\$5,120.00	
Cash		\$5,100.00
Exchange (or Purchases)		20.00

On the other hand, if the rate at the date of settlement is 5.15, the entry to record the settlement will be:

London Manufacturer	\$5,120.00	
Exchange (or Purchases)		30.00
Cash		\$5,150.00

If the Chicago merchant desires to protect himself against speculative risks from exchange fluctuations, he may, at the time of purchasing the goods, buy future exchange on London, the delivery of the future to be made to him at the date when he will require it for the settlement of his invoice.

Foreign sales.—An American, selling goods abroad, may bill in dollars or in foreign currency. If the American bills in dollars, the foreign purchaser will make the gain or bear the loss resulting from any exchange fluctuation. If the American bills in the foreign currency, he will make the gain or bear the loss. To illustrate, assume that a Chicago manufacturer sells a bill of goods to a London merchant for £1,000. The rate at the date of sale is 5.12, and the sale is recorded as follows:

London Merchant.....	\$5,120.00	
Sales.. .. .		\$5,120.00

A memorandum of the pound amount must be made in the London merchant's account on the Chicago manufacturer's books, or this account may be kept in both pounds and dollars.

If the rate is 5.15 when the Chicago manufacturer receives the London merchant's draft for £1,000, the Chicago merchant's bank will pay \$5,150.00 for the draft, and the entry will be:

Cash.....	\$5,150.00	
London Merchant.....		\$5,120.00
Exchange (or Sales)		30.00

If the rate at settlement time is 5.10, the entry will be:

Cash.....	\$5,100.00	
Exchange (or Sales)		20.00
London Merchant.....		\$5,120.00

If the Chicago merchant who sells goods and bills them in pounds, wishes to protect himself against exchange fluctuations, he may sell future exchange on London for £1,000 for delivery at the date when he expects to receive the draft for £1,000.

Foreign branches.—The methods of accounting for foreign branches are similar to the methods described in the chapter

on domestic branches; but the problem is complicated by the fact that the home office books are kept in terms of the domestic currency whereas the branch books are kept in terms of the foreign currency. This complication is faced:

- (1) During the accounting period when:
 - (a) Cash or merchandise is transferred from the home office to the branch, or vice versa; or when,
 - (b) Any transaction which is recorded in one currency on one set of books must also be recorded at an equivalent value in the other currency on the other set of books.
- (2) At the end of the period when:
 - (a) The branch profit, computed on the branch books in the foreign currency, must be recomputed in the domestic currency and taken up on the home office books; and when
 - (b) The branch profit and loss statement must be combined with the home office profit and loss statement; and when
 - (c) The branch balance sheet must be combined with the home office balance sheet.

Some of the features peculiar to foreign branch accounting may be explained by carrying an illustration through the following steps:

- (1) Entries for transactions of the period.
- (2) Closing the branch books, and preparing branch statements in foreign currency.
- (3) Conversion of branch trial balance, to obtain dollar values to be used in:
 - (a) Branch profit and loss statement expressed in dollars, thus determining the net profit to be taken up by the home office.
 - (b) Branch balance sheet expressed in dollars.

Illustration.—The following transactions form the basis of the illustration:

- (1) The home office, in Chicago, opens a London branch, sending it a draft for £1,000, which the home office pur-

chases when the rate is 5.18.

- (2) The home office sends the branch a draft for \$2,600.00. When the branch receives this draft and deposits it, the rate is 5.20; the London bank therefore credits the branch with £500.
 - (3) The home office sends to the branch goods valued at \$51,900.00, which is cost. The shipment is made when the exchange rate is 5.19, and the goods are therefore taken up on the branch books at £10,000.
 - (4) Purchases on account, made by the branch in England, £3,000.
 - (5) Payments made to creditors on account of above purchases, £2,500.
 - (6) Sales on account, £16,000.
 - (7) Collections on account, £15,000.
 - (8) Expenses paid, £2,000.
 - (9) The branch sends the home office a draft for £5,000, which the home office sells at 5.21, realizing \$26,050.00.
 - (10) The branch sends the home office a draft for \$31,140.00, which it purchased at 5.19, the cost being £6,000.
- The branch inventory at the end of the year is valued at £2,000.

Entries during the period.—Entries for transactions which are recorded only on the branch books present no new features and no difficulties. Reference to the illustrative entries on page 435 will show that transactions 4, 5, 6, 7, and 8, which appear on the branch books only, are recorded in the manner described in the chapter on domestic branches; the entries are recorded in the foreign currency only and the problem of conversion to domestic currency does not arise.

When cash is sent from the home office to the branch, the home office records the dollar cost of the remittance, and the branch records the pounds received. In transaction 1, the home office buys a £1,000 draft for 5.18. The cost is therefore \$5,180.00, and the remittance is recorded on the home office books at this figure and taken up on the branch books at £1,000. In transaction 2, the home office sends a draft for \$2,600.00, and the branch records the receipt of the funds at the number of pounds received when the draft is deposited. Thus, in the first transaction, the rate at the date of purchase governs the conversion; whereas, in the second transaction, the rate at the date of deposit by the branch governs the conversion.

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	Branch Books		Home Office Books
(1) Cash.....	£ 1,000		Remittances to Branch
Remittances from Home Office.....	£ 1,000		\$ 5,180
			Cash.....
			\$ 5,180
(2) Cash.....	500		Remittances to Branch
Remittances from Home Office.....	500		2,600
			Cash.....
			2,600
(3) Merchandise from Home Office	10,000		Branch Current....
Home Office Current ...	10,000		51,900
			Shipments to Branch
			51,900
(4) Purchases	3,000		
Accounts Payable.....	3,000		
(5) Accounts Payable.	2,500		
Cash.....	2,500		
(6) Accounts Receivable.....	16,000		
Sales.....	16,000		
(7) Cash.....	15,000		
Accounts Receivable....	15,000		
(8) Expense.....	2,000		
Cash.....	2,000		
(9) Remittances to Home Office	5,000		Cash.....
Cash.....	5,000		26,050
			Remittances from Branch
			26,050
(10) Remittances to Home Office	6,000		Cash.....
Cash.....	6,000		31,140
			Remittances from Branch
			31,140

It should be noted that, in the illustrative entries, the home office debits Remittances to Branch, instead of debiting the Branch Current account; and the branch credits Remittances from Home Office, instead of crediting the Home Office Current account. These entries are made so that

reciprocal accounts on the two books will show the value, in dollars and in pounds, of funds sent from the home office to the branch. These reciprocal accounts will be found useful when the branch trial balance is converted into domestic currency at the end of the period.

The goods sent by the home office to the branch (transaction 3) are credited by the home office to Shipments to Branch at cost, and are taken up on the branch books at the current exchange value at the date of shipment.

Cash remittances from the branch to the home office are illustrated by the last two transactions. In 9, the branch buys a £5,000 draft, and the dollar value is determined when the home office sells it. In 10, the branch buys a draft for \$31,140.00, paying for it at the rate of 5.19, the pound and dollar values both being known at the date of purchase. It should be noted that the branch charges Remittances to Home Office instead of the Home Office Current account, and the home office credits Remittances from Branch instead of Branch Current, for the purpose of providing reciprocal accounts showing the dollar and pound values of the remittances.

Branch closing and statements.—At the close of the accounting period, the branch draws off the following trial balance:

Cash.....	£ 1,000	
Accounts Receivable.....	1,000	
Remittances to Home Office.....	11,000	
Accounts Payable.....		£ 500
Remittances from Home Office.....		1,500
Home Office Current.....		10,000
Sales.....		16,000
Merchandise from Home Office.....	10,000	
Purchases.....	3,000	
Expense.....	2,000	
	<u>£28,000</u>	<u>£28,000</u>

Inventory—£2,000.

The branch then closes its books and prepares statements, as follows:

Profit and Loss.....	£15,000	
Merchandise from Home Office.....		£10,000
Purchases.....		3,000
Expense.....		2,000

Inventory.....	2,000	
Sales.....	16,000	
Profit and Loss.....		18,000
Profit and Loss.....	3,000	
Home Office Current.....		3,000
Home Office Current.....	11,000	
Remittances to Home Office.....		11,000
Remittances from Home Office.....	1,500	
Home Office Current.....		1,500

Branch Profit and Loss Statement
For the Year Ended December 31, 193-

Sales.....		£16,000
Less Cost of Goods Sold:		
Merchandise from Home Office.....	£10,000	
Purchases.....	3,000	
Total.....	£13,000	
Less Inventory—December 31.....	2,000	11,000
Gross Profit on Sales.....		£ 5,000
Less Expense.....		2,000
Net Profit.....		<u>£ 3,000</u>

Statement of Home Office Current Account

(On Branch Books)

Remittances to Home Office	£11,000	Merchandise from Home Office	£10,000
Balance, December 31.....	3,500	Remittances from Home Office	1,500
		Net Profit.....	3,000
	<u>£14,500</u>		<u>£14,500</u>

Branch Balance Sheet

December 31, 193-

Assets		Liabilities	
Cash.....	£ 1,000	Accounts Payable.....	£ 500
Accounts Receivable.....	1,000	Home Office Current.....	3,500
Inventory.....	2,000		
	<u>£ 4,000</u>		<u>£ 4,000</u>

Conversion of branch trial balance.—The branch sends the home office copies of its trial balance, inventory, closing entries, profit and loss statement, statement of the Home Office Current account, and balance sheet. As the trial balance and inventory furnish the basis for all of the other statements, the home office proceeds to convert the trial balance and inventory from pounds to dollars, so that:

- (1) The net profit can be taken up on the home office books.

- (2) The home office and branch profit and loss statements can be combined.
- (3) The home office and branch balance sheets can be combined.

The following rules have come to be accepted as standard practice for making the conversions from foreign to domestic currency:

Current assets (including the final inventory) and current liabilities: at the rate which is current at the end of the period. This rate is used because it furnishes the best evidence of the present value of the assets (which presumably will shortly be converted into cash that may be remitted to the home office) and the present liability on current debts.

Fixed assets: at the rate which was current at the time when the assets were purchased. The reason for using this rate is fully discussed in a later section of this chapter.

Inventory at the beginning of the period: at the rate which was current at that date. This rate is used because, at the beginning of the period, the inventory was a current asset and was converted at the then current rate; as this inventory was the closing inventory in one statement and will be the opening inventory in the next statement, it should appear in the two statements at the same dollar value, and such a value can be obtained only by converting the inventory at the same rate for both statements.

Nominal accounts: at an average rate for the period. This average rate may be determined in several ways: by averaging the daily rates for the year; by averaging twelve monthly rates; by using a weighted average which gives more importance to the rates prevailing during busy seasons than to the rates prevailing during slack seasons; or by dividing the balance of the branch account, Remittances to Home Office (pounds), into the balance of the home office account, Remittances from Branch (dollars), thus determining the average rate at which profits were transferred to the home office in the form of cash.

Accrued expense and income, and deferred charges and expenses. These items have two aspects: On the one hand, they affect the nominal items that appear in the profit and loss statement; and on the other hand, they enter into the balance sheet. As nominal items they should be converted at an average rate, while as assets and liabilities they should be converted at the current rate. But it is impossible to convert them at both rates. As the items are generally so small in amount that they are relatively insignificant, it is usually satisfactory to convert them at the current rate for both purposes. Or an adjusted trial balance in the foreign currency may be prepared, in which the expense and income accounts will have been charged and credited with the adjusting items; the nominal accounts, as adjusted, can then be converted at an average rate; and the accrued and deferred items, which will appear in the balance sheet, can be converted at the current rate.

Reserves. The rate at which a reserve should be converted will depend on the nature of the reserve. If it represents a current liability, it should be converted at the current rate. If it is a valuation reserve set up against a current asset, as the Reserve for Bad Debts, it should be converted at the current rate, since the asset is converted at that rate. The Reserves for Depreciation should be converted at the same rates as the fixed asset accounts. But since a fixed asset account may contain charges for purchases made at various dates (so that the balance must be divided into several portions, and each converted at a different rate), it is better to compute the dollar, or converted, reserve on a percentage basis. Thus, if the reserve on the foreign books is 15% of the asset, the reserve may be converted into dollars by multiplying the dollar value of the asset by 15%, instead of using an exchange rate.

Reciprocal accounts: at the dollar balances of the accounts on the home office books, without using any rate; thus:

Remittances from Home Office, at the dollar balance of the home office account, Remittance to Branch.

Remittances to Home Office, at the dollar balance of the home office account, Remittances from Branch.

Merchandise from Home Office, at the dollar balance of the home office account, Shipments to Branch.

Home Office Current account, at the dollar balance of the Branch Current account on the home office books.

The branch trial balance, stated in pounds, will balance when sent by the branch to the home office, but it will not balance after the home office has converted the amounts into dollars, because the items will have been converted at different rates. Therefore an adjusting figure must be entered on the smaller side of the branch trial balance after conversion. This adjustment is supposed to measure the profit or the loss due to exchange fluctuations. If the figure must be entered on the debit side of the branch trial balance, it is a loss; if it must be entered on the credit side of the trial balance, it is a gain. The final disposition of this adjustment in the home office closing entries is discussed on page 443.

Branch Trial Balance
December 31, 193-

	<u>Pounds</u>	<u>Rate</u>	<u>Dollars</u>	
Cash.....	£ 1,000	C	\$ 5,200	
Accounts Receivable.....	1,000	C	5,200	
Remittances to Home Office....	11,000	R	57,190	
Accounts Payable	£ 500	C	\$ 2,600	
Remittances from Home Office.....	1,500	R	7,780	
Home Office Current.....	10,000	R	51,900	
Sales.....	16,000	A	83,040	
Merchandise from Home Office.....	10,000	R	51,900	
Purchases.....	3,000	A	15,570	
Expense	2,000	A	10,380	
	<u>£28,000</u>	<u>£28,000</u>	<u>\$145,440</u>	<u>\$145,320</u>
Exchange Adjustment.....				120
			<u>\$145,440</u>	<u>\$145,440</u>
Inventory—December 31.....	£ 2,000	C	\$ 10,400	

Rate symbols:

C = Current rate: 5.20.

A = Average rate: 5.19.

R = Balance of reciprocal account on home office books. See home office trial balance, page 441.

Branch profit and loss statement.—From the figures in the converted trial balance, the following profit and loss statement may be prepared in dollars:

Branch Profit and Loss Statement
For the Year Ended December 31, 193-

Sales.....		\$83,040.00
Less Cost of Goods Sold:		
Merchandise from Home Office.....	\$51,900.00	
Purchases.....	15,570.00	
Total.....	<u>\$67,470.00</u>	
Less Inventory, December 31..	10,400.00	57,070.00
Gross Profit on Sales.....		\$25,970.00
Less Expense.....		10,380.00
Net Profit.....		<u>\$15,590.00</u>

Branch balance sheet.—The converted trial balance and final inventory also furnish the information for the following branch balance sheet:

Branch Balance Sheet
December 31, 193-

Assets:		
Cash.....	\$ 5,200.00	
Accounts Receivable.....	5,200.00	
Merchandise Inventory.....	<u>10,400.00</u>	\$20,800.00
Liabilities:		
Accounts Payable.....		<u>2,600.00</u>
Net Assets.....		<u>\$18,200.00</u>

Home office closing entries.—The home office trial balance at the end of the year is shown below:

Cash.....	\$ 27,410.00	
Accounts Receivable.....	31,000.00	
Branch Current.....	51,900.00	
Remittances to Branch.....	7,780.00	
Accounts Payable.....		\$ 6,000.00
Remittances from Branch.....		57,190.00
Capital Stock.....		50,000.00
Sales.....		150,000.00
Shipments to Branch.....		51,900.00
Purchases.....	175,000.00	
Expense.....	22,000.00	
	<u>\$315,090.00</u>	<u>\$315,090.00</u>

Inventory, December 31, \$10,000.00.

The home office closing entries may be divided into three groups:

- (a) Entries to determine the profit from home office operations.
- (b) Entries to take up the branch profit and to close the

temporary accounts with the branch.

- (c) Entries to adjust the balance of the Branch Current account to bring it into agreement with the net assets at the branch.

These entries are illustrated below.

- (a) *Entries to determine the profit from home office operations.*

Shipments to Branch.....	\$ 51,900.00	
Purchases.....		\$ 51,900.00
To credit Purchases with the cost of goods sent to branch.		
Profit and Loss.....	145,100 00	
Purchases.....		123,100.00
Expense.....		22,000.00
Inventory, December 31.....	10,000 00	
Sales.....	150,000 00	
Profit and Loss.....		160,000.00

The balance of the Profit and Loss account is now \$14,900.00, the amount of the home office profit from operations.

- (b) *Entries to take up the branch profit and to close the temporary accounts with the branch.*

Branch Current.....	\$15,590.00	
Branch Profit and Loss.....		\$15,590.00
To take up the net profit of the branch, as shown by the branch profit and loss statement converted into dollars.		
Branch Current.....	7,780.00	
Remittances to Branch.....		7,780.00
To close the temporary remittances account.		
Remittances from Branch.....	57,190.00	
Branch Current.....		57,190.00
To close.		

Finally, the home office will close both the home office profits and the branch profits into surplus by the following entry:

Profit and Loss.....	\$14,900.00	
Branch Profit and Loss.....	15,590.00	
Surplus.....		\$30,490.00

(c) *Entries to adjust the balance of the Branch Current account to bring it into agreement with the net assets at the branch.*—After the foregoing entries affecting the Branch Current account have been made, this account on the home office books will appear as follows:

Branch Current	
Shipments to Branch . . . \$51,900.00	Remittances from Branch \$57,190.00
Branch Profit 15,590 00	
Remittances to Branch . . 7,780.00	

The balance of this account is now \$18,080.00, but the branch balance sheet on page 441 shows that the net assets at the branch are valued at \$18,200.00. In other words, the balance of the Branch Current account is \$120.00 smaller than the value of the net assets at the branch. When the combined balance sheet of the home office and the branch is prepared, the balance of the Branch Current account on the home office books will be eliminated, and will be replaced by the assets and liabilities of the branch. This cannot be done unless the balance of the Branch Current account on the home office books is exactly equal to the net assets at the branch.

It therefore becomes necessary to debit the Branch Current account, \$120.00. It will be noted that this \$120.00 is the amount of the adjustment entered in the branch trial balance after conversion (see page 440), and attention has already been called to the fact that this adjustment represents the profit or loss on exchange. The question now arises concerning the proper offsetting entry. Two common methods are in use.

First, the exchange adjustments may be made through Branch Profit and Loss. If the Branch Current account balance must be increased to make it agree with the branch net assets, the offsetting credit may be made to Branch Profit and Loss before the balance of that account is transferred to Surplus. If the current account balance must be decreased, the offsetting debit may be to Branch Profit and Loss. Making the adjustment through Branch Profit and Loss may be justified on the theory that the branch profit as computed (and charged to Branch Current account and credited to Branch Profit and Loss) is an estimate based on the use of

arbitrary rates; hence the exchange adjustment is a correction of this estimate.

Second, the exchange adjustment may be made through a Reserve for Exchange, on the theory that the exchange fluctuation is an unrealized and an uncertain matter, and that any profits which seem to have been made by a favorable fluctuation during one year may be offset by losses from unfavorable fluctuations in a succeeding year. Therefore it is more conservative to credit the exchange adjustment to a reserve, where it will be available to absorb exchange losses in the future. If no reserve exists, an exchange loss should be charged to Profit and Loss; and if the loss exceeds the reserve, the excess should be charged to Profit and Loss.

Adopting the second procedure as the more conservative, the closing of the home office books would be completed by the following entry:

Branch Current	\$120.00	
Reserve for Exchange.....		\$120.00

Combined statements.—The following exhibits show the working papers from which the combined balance sheet is prepared, and the combined profit and loss statement.

THE X Y Z COMPANY
Combined Balance Sheet Working Papers
December 31, 193-

	Home Office	Branch	Elimi- nations	Combined Balance Sheet
Assets				
Cash.....	\$27,410.00	\$ 5,200.00		\$32,610.00
Accounts Receivable....	31,000.00	5,200.00		36,200.00
Inventory.....	10,000.00	10,400.00		20,400.00
Branch Current.....	18,200.00		\$18,200.00	
	<u>\$86,610.00</u>	<u>\$20,800.00</u>	<u>\$18,200.00</u>	<u>\$89,210.00</u>
Liabilities and Net Worth				
Accounts Payable.....	\$ 6,000.00	\$ 2,600.00		\$ 8,600.00
Reserve for Exchange...	120.00			120.00
Capital Stock.....	50,000.00			50,000.00
Surplus.....	30,490.00			30,490.00
Home Office Current....		18,200.00	\$18,200.00	
	<u>\$86,610.00</u>	<u>\$20,800.00</u>	<u>\$18,200.00</u>	<u>\$89,210.00</u>

THE X Y Z COMPANY
Home Office and Branch Profit and Loss Statement
For the Year Ended December 31, 193-

	Home Office	Branch	Combined
Sales.....	\$150,000.00	\$83,040.00	\$233,040.00
Less Cost of Goods Sold:			
Purchases.....	\$175,000.00	\$15,570.00	\$190,570.00
Transfers from Home Office to Branch.....	51,900.00	51,900.00	
Net and Total.....	\$123,100.00	\$67,470.00	
Less Inventory, December 31.....	10,000.00	10,400.00	20,400.00
Cost of Goods Sold.....	113,100.00	57,070.00	170,170.00
Gross Profit on Sales.....	\$ 36,900.00	\$25,970.00	\$ 62,870.00
Less Expense.....	22,000.00	10,380.00	32,380.00
Net Profit.....	\$ 14,900.00	\$15,590.00	\$ 30,490.00

Conversion of nominal accounts.—In the preceding illustration, the standard rule of converting nominal account balances at an average rate has been applied. It seems, however, that, in determining what rate to use, consideration should be given to the difference between the branch net assets at the beginning and at the end of the period.

If the branch net assets were approximately the same at the beginning and the end of the period, it is apparent that the profits have been transferred to the home office by remittances. This means that the profits have been converted into cash, and the average rate at which the profits have been transferred in cash to the home office can be determined by dividing the dollar balance of the home office account, Remittances from Branch, by the pound balance of the branch account, Remittances to Home Office. It would seem logical in such cases to use this average rate in converting the nominal account balances.

On the other hand, if the branch net assets have increased during the period by an amount approximately equal to the profits of the period, it is apparent that the profits remain at the branch, probably in increased net current assets. As these current assets are converted at the current rate, it seems logical in such cases to convert the nominal accounts at the current rate. That is, if the current asset accounts, which show how the profits are invested, are converted at the current rate, it is consistent to use the current rate in converting the nominal accounts, which measure the profits.

In the preceding illustration, the branch began the year with no assets; during the year its profits were £3,000; at the end of the period its net current assets were £3,500. The profits therefore remain at the branch. Converting nominal accounts at the 5.20 rate, current at the end of the year, would cause the branch profit and loss statement to appear as follows:

Sales.....		\$83,200.00
Less Cost of Goods Sold:		
Purchases.....	\$15,600.00	
Merchandise from Home Office.....	51,900.00	
Total.....	\$67,500.00	
Less Inventory, December 31.....	10,400.00	57,100.00
Gross Profit on Sales.....		\$26,100.00
Less Expense.....		10,400.00
Net Profit.....		<u>\$15,700.00</u>

The profit and loss statement in which nominal account balances were converted at the average rate, showed a net profit of \$15,590.00, and an exchange adjustment debiting the Branch Current account \$120.00, was necessary. The statement just given shows profits of \$15,700.00, or an increase of \$110.00. Therefore, a debit exchange adjustment of \$10.00, instead of \$120.00, should be made in the Branch Current account. It is apparent that this method reduces the amount of the exchange adjustment. But this will be true only when the increase in the branch's net assets during the period results from branch profits and is approximately equal to the profit.

Branch fixed assets.—There is a general accounting principle which requires that profits and surplus shall not be affected by valuing fixed assets at market prices. According to this principle, it is improper to convert branch fixed assets at current exchange rates, if such rates are higher or lower than the rates prevailing at the dates of acquisition of the fixed assets, because the assets would thus be virtually written up or down as the result of a market fluctuation.

Since branch fixed assets should always be converted at the rate which prevailed at the date of acquisition, it is necessary to provide some accounting method by which the dollar value of foreign currency expenditures for fixed assets can be easily ascertained. For, if expenditures for branch fixed assets are made frequently, many different rates will exist because of different acquisition dates, and each rate will apply to a portion of the fixed asset account.

If the fixed asset accounts are kept on the branch books, two money columns should appear on each side. Expenditures made by the branch should be charged to the account in pounds, with a memorandum in the inner, or dollar, column, showing the current value of the pounds spent. If fixed assets are purchased by the home office and sent to the branch, the home office should charge the Branch Current account with the dollars spent, and notify the branch of the equivalent pound and dollar values at the date the expenditure was made. The branch will then debit the fixed asset accounts at both the dollar and pound values, and credit the Home Office Current account at the pound value. The fixed asset accounts will

thus show the dollar cost of the fixed assets, as well as the pound cost; and the dollar cost thus shown will be used when the branch trial balance is converted into dollars. The depreciation reserve stated in pounds on the branch books will be converted into dollars on a percentage basis. For instance, if the balance in the reserve on the branch books is 25% of the asset account balance, the reserve should be 25% of the asset balance stated in dollars.

The problems of conversion can be simplified by carrying the branch fixed assets in dollars on the home office books. If this practice is followed, any expenditure made by the branch for fixed assets will be charged to the Home Office Current account in pounds. The branch will notify the home office of the expenditure and of the rate prevailing at the date of the expenditure, and the home office will debit branch fixed assets (in properly classified accounts) and credit the Branch Current account at the dollar value obtained by converting at the stated rate. Any expenditures made by the home office will be charged to the branch fixed asset accounts on the home office books.

When the fixed assets are carried on the home office books, the depreciation reserves will also be set up on these books; after the home office has taken up the profit reported by the branch, an entry will be made debiting Branch Profit and Loss and crediting the depreciation reserve.

Expenses incurred by the home office for the benefit of the branch may be charged against the Branch Profit and Loss account in a similar manner, or may be charged to the Branch Current account and taken up on the branch books by debits to expense accounts and a credit to the Home Office Current account.

CHAPTER 54

FOREIGN EXCHANGE (Concluded)

Foreign sales agency.—One characteristic difference between an agency and a branch is that the former does not keep its own accounts receivable whereas the latter does. We therefore have the problem of considering the records to be kept by a concern which maintains a foreign agency.

The agency will probably be supplied with a working fund; the first draft sent to the agency will be charged to Foreign Agency Working Fund at the cost of the draft; later replenishing drafts will be charged to Agency Expense. At the end of the period, when the books are closed, the balance of cash at the agency should be converted at the current rate, and any difference between the value thus determined and the balance of the Agency Working Fund account should be taken up as a debit or a credit to Exchange.

If sales are billed in United States currency, no special conversion problems arise. A separate foreign sales book may be kept if desired, and the foreign accounts receivable may be kept in a separate subsidiary ledger. But sales, returns and allowances, and remittances will all be on a dollar basis, and no exchange adjustments will need to be made.

If sales are billed in the foreign currency, the problem is more difficult. The simplest way to deal with it is to keep a separate set of books of original entry for foreign business. The sales book will have a Foreign Amount column and a Dollar Amount column. Entries will be made for the foreign billing and for the dollar value thereof at the time of the sale. When postings are made to the subsidiary accounts receivable ledger, the foreign amount will be entered in an inner, or memorandum, column, and the dollar amount in the outer column. A Foreign Accounts Receivable controlling account will be kept in the general ledger, charged in an inner column with the foreign amount of sales, and in an outer column with the dollar amount. This general ledger account will thus

control the subsidiary ledger both in foreign and in dollar amounts. The total of the Dollar column of the sales book will be posted also to the credit of Foreign Agency Sales.

If returns and allowances are sufficiently frequent to warrant it, a foreign returned sales and allowances book may be kept with two money columns; the detail in both currencies will be posted to the credit of the personal accounts in the subsidiary ledger; both column totals will be posted to the Foreign Accounts Receivable controlling account; and the total of the Dollar column will be posted to the Foreign Agency Returned Sales and Allowances account. If returned sales and allowances are rarely made, they can be entered in the foreign journal, which can also be used for notes and other time paper.

The foreign cash receipts book will need columns as follows:

<u>Date</u>	<u>Name</u>	<u>Explanation</u>	<u>Foreign Amount</u>	<u>Dollar Amount</u>	<u>Loss on Exchange</u>	<u>Profit on Exchange</u>	<u>Bank</u>
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To illustrate the use of such a cash book, assume that an American exporter sells to an English importer an invoice of £1,000 at a time when the rate is 5.17. The English importer obtains an allowance of £10 at a time when the rate is 5.18. The allowance can be converted at the rate which was current when the sale was made, or at the rate current at the date of the allowance, whichever is more readily ascertainable. The choice of rate will affect merely the final exchange adjustment. Assuming that the allowance is converted at the current rate of 5.18, the debtor's account in the subsidiary ledger will appear as follows:

English Importer							
		<u>£</u>	<u>\$</u>		<u>£</u>	<u>\$</u>	
Sale.....		1,000	5,170.00	Allowance.....	10	51.80	

The indebtedness is now £990, and is represented by a dollar balance of \$5,118.20.

The account is settled by a draft for £990, which is sold by the American at 5.175, or for \$5,123.25. An entry will be made in the cash book as follows:

<u>Date</u>	<u>Name</u>	<u>Explan- ation</u>	<u>Foreign Amount</u>	<u>Dollar Amount</u>	<u>Loss on Exchange</u>	<u>Profit on Exchange</u>	<u>Bank</u>
Dec. 14	English Importer		£990	\$5,118.20		\$5.05	\$5,123.25

The entries in the Foreign Amount and Dollar Amount columns will be posted to the subsidiary ledger account, thus balancing it. The totals of these two columns will be posted to the Foreign Accounts Receivable controlling account. The totals of the Exchange columns will be posted to Exchange, and the total of the Bank column will be charged to the Bank account in the general ledger. Ignoring the pound entries, which are for memorandum only, the cash book entry is equivalent to the following journal entry:

Bank (for proceeds of draft).....	\$5,123.25	
London Importer (to balance account)		\$5,118.20
Exchange.....		5.05

At the close of the accounting period, the pound balance of the Foreign Accounts Receivable controlling account may be converted into dollars at the current rate of exchange, and any profit or loss may be taken up by the method followed by banks in computing profit on foreign exchange dealings. (See page 429.)

Foreign purchasing agency.—The methods just described may be followed by a concern operating an agency abroad for the purpose of making purchases which are billed to and paid by the home office in terms of foreign currency. A foreign purchase book, returned purchases and allowances book, journal, cash disbursements book, Accounts Payable account, and subsidiary accounts payable ledger would be kept. Postings would be made in the manner similar to that described for a sales agency.

Foreign manufacturing plant.—If a foreign factory is established, the accounting problem is one of computing costs rather than of computing profits. Instead of forwarding merchandise to the branch and receiving cash in return, the home office sends cash, and perhaps supplies, to the foreign factory and receives finished goods. The problem may also be complicated by the fact that a plant is constructed, in which case it will be necessary to ascertain the dollar cost of the plant as well as the dollar cost of the product.

Exchange rates will affect costs of construction and production by determining the number of units of foreign currency obtained from home office remittances; and con-

struction and production should be charged with the dollar cost of the foreign money used for these purposes. Therefore the foreign factory books should be kept in both currencies.

Drafts received from the home office will be converted into foreign currency at different rates at different dates during the period; the Cash account should show the dollars remitted and the foreign currency obtained. When payments are made, the construction and production accounts should be charged with the foreign currency spent, and with the dollar cost thereof. This dollar cost may be computed on the first-in first-out theory, or by the use of an average rate. The following illustration shows the principles and general methods applied, using the first-in first-out theory. The illustration is limited to production, the costs of which are charged directly to Finished Goods; it is understood, of course, that in practice detailed manufacturing accounts would be kept.

The home office sends a draft of \$52,000.00, which is converted into pounds on January 3, at 5.20.

The branch pays £5,000 for raw materials on January 8. (As the only cash on hand cost 5.20, production is charged at that rate.)

The branch pays £3,000 for labor on January 9, charging production at the 5.20 rate.

The home office sends a draft for \$52,100.00, which is converted into pounds on January 10, at 5.21.

The branch pays £3,000 for manufacturing expenses on January 12; £2,000 of the first remittance was available for this payment, the dollar cost of which, at 5.20, was \$10,400.00.

The remaining £1,000 is assumed to have been paid from the second remittance, the dollar cost of which, at 5.21, was \$5,210.00.

The branch ships half of its manufactured product to the home office on January 13.

The branch accounts are illustrated on the opposite page.

The branch trial balance will appear as follows:

	Dollars	Pounds	
Home Office Current..	75,495.00		14,500
Cash.....	46,890.00	9,000	
Finished Goods.....	28,605.00	5,500	
	<u>75,495.00</u>	<u>14,500</u>	<u>14,500</u>

Home Office Current

	\$	Rate	£		\$	Rate	£
Jan. 13 Merchandise.....	28,605.00	5.2009	5,500	Jan. 3 Cash.....	52,000.00		10,000
Balance.....	75,495.00		14,500	10 Cash.....	52,100.00		10,000
	<u>104,100.00</u>		<u>20,000</u>	Balance	<u>104,100.00</u>		<u>20,000</u>
					75,495.00		14,500

Cash

	\$	Rate	£		\$	Rate	£
Jan. 3 Home Office.....	52,000.00	5.20	10,000	Jan. 8 Materials.....	26,000.00		5,000
10 Home Office.....	52,100.00	5.21	10,000	9 Labor.....	15,600.00		3,000
	<u>104,100.00</u>		<u>20,000</u>	12 Manufacturing Expense...	10,400.00		2,000
	46,890.00	5.21	9,000	12 Manufacturing Expense...	5,210.00		1,000
Balance.....	<u>104,100.00</u>		<u>20,000</u>	Balance.....	<u>46,890.00</u>		<u>9,000</u>
	46,890.00	5.21	9,000		104,100.00		20,000

Finished Goods*

	\$	Rate	£		\$	Rate	£
Jan. 8 Materials.....	26,000.00	5.20	5,000	Jan. 13 Home Office.....	28,605.00		5,500
9 Labor.....	15,600.00	5.20	3,000	Inventory.....	28,605.00		5,500
12 Manufacturing Expense...	10,400.00	5.20	2,000		<u>57,210.00</u>		<u>11,000</u>
12 Manufacturing Expense...	5,210.00	5.21	1,000				
Inventory.....	<u>57,210.00</u>		<u>11,000</u>				
	28,605.00	5.2009	5,500				

* To simplify the illustration, all manufacturing costs are charged to this account. In practice, detailed cost accounts should be kept; the method of determining the dollar charges to these accounts would be the same as illustrated.

The home office account with the branch will appear as follows:

Branch Current			
Cash	\$ 52,000 00	Merchandise	\$ 28,605 00
Cash	52,100.00	Balance	75,495 00
	\$104,100.00		\$104,100 00

The balance of the account agrees with the net assets at the foreign plant, as stated in the Dollar columns of the branch trial balance.

If construction and production are carried on simultaneously, the fixed asset accounts should be charged with the dollar value of the pounds expended; this dollar value should be computed in the same way as the dollar value of the pounds spent for production.

If materials and supplies are sent from the home office to the branch, they should be converted from dollars to pounds at the date of arrival, and charged to the Materials and Supplies account in both currencies, as is done with cash. Materials and supplies requisitioned out of stores should be credited to the account at two values; if several shipments have been received, the dollar value should be ascertained at an average rate or by the first-in first-out method.

If there are any current liabilities in the foreign country for operating or construction costs, it would seem proper to convert these liabilities (for the purpose of combining the branch and home office statements) at the rate at which the cash on hand was converted, provided there is sufficient cash on hand to pay these debts. If there is not sufficient cash on hand to pay the debts, the excess should be converted at the current rate, because, presumably, the debts will be paid partly with cash on hand which was obtained at a past rate, and partly with cash to be received in the future. The present current rate is the best evidence of what this future cash will cost in dollars.

The foreign subsidiary.—Foreign branches may be, and frequently are, organized as separate companies, incorporated under the laws of a foreign country. In such cases the parent company should charge the Investment in Foreign Subsidiary account with the dollar cost of the stock, and with its share of the subsidiary profits; and should credit the Investment

account with the dollar proceeds of drafts received as dividends. When the balance sheets are consolidated, the subsidiary Capital Stock account should be converted at the dollar price paid by the parent company, and the subsidiary Surplus account should be arbitrarily stated at an amount which will bring the subsidiary balance sheet into balance after conversion into dollars. If the parent company's Investment account does not agree with the subsidiary's capital stock plus surplus as thus converted (assuming 100% ownership), an adjusting journal entry should be made debiting or crediting the Investment Account, with an offsetting debit or credit to Profit and Loss or to a Reserve for Exchange.

The parent company will bill goods to the subsidiary and will keep a current account to record such charges, crediting the current account with payments made against invoices. The parent company may bill in dollars or in the foreign currency. If the parent company bills in dollars, the foreign subsidiary will convert the invoice to foreign currency at the rate prevailing at the date the goods are received, recording the dollar liability in an inner column of the Parent Company Current account. If invoices are paid by dollar drafts, and if there has been a change in rate between the date of receipt of the goods and the date of payment, the cost of the draft in foreign currency will be more or less than the foreign currency credit to the parent company made by the subsidiary at the time of receiving the goods. This difference will be a debit or a credit to Exchange on the foreign subsidiary's books. Columns may be provided in the cash book for this loss or gain, as described in the section on "Foreign sales agency," on page 449; or the loss or gain may be taken up by a journal entry.

If the parent company bills in the foreign currency, it will be necessary to keep the Foreign Subsidiary Current account on the home office books in both currencies; any loss or gain due to fluctuations in exchange between the date of shipment and the date of collection will be taken up on the parent company's books.

The fixed asset accounts of the foreign subsidiary should be kept in both currencies, and the dollar value of expenditures entered in an inner memorandum column at the rate

prevailing at the date of the expenditure. This inner column will furnish the information required to convert the fixed assets from foreign to domestic currency, without introducing an element of variation due to exchange fluctuations.

The consolidation of the statements will be made in much the same manner as is followed in the consolidation of the statements of a parent and subsidiary both of which are incorporated in the same country. If there is a minority interest, it will have to be shown; if goods are billed to the subsidiary at a profit, a reserve for the unrealized profit in the inventory will have to be provided; and all of the other complications discussed in the chapters on consolidated statements may have to be faced. For our present purposes, however, the chief question of interest is the one of conversion; therefore all possible complications will be avoided in the illustration which follows; it should be understood that problems peculiar to consolidated statements (whether the subsidiary is a domestic or a foreign corporation) would be dealt with in the manner described in the chapters on consolidated statements.

Illustration.—Following are a number of typical transactions, with journal entries, indicating how the transactions would be recorded on the books of the domestic parent company and the foreign subsidiary. The parent company's entries are at the left, and the subsidiary's entries at the right.

- (1) The United States Company organized a foreign subsidiary called the London Company, with a capital stock of £10,000. The United States Company paid for this stock with a £10,000 draft purchased at 5.20.

(Note.—It is desirable to make a memorandum in the foreign Capital Stock account showing the cost of this stock to the parent company in dollars, because the parent company's Investment account will receive other entries for earnings, dividends, and exchange adjustments, so that the balance will not be the dollar cost of the stock. This dollar memorandum, to be made on the subsidiary's books, is indicated in the following entry.)

Investment in Lon-		Cash.....	£10,000
don Co.....	\$52,000	Capital Stock	
Cash.....	\$52,000	(\$52,000)..	£10,000

- (2) The London Company purchased a complete plant for £7,000; the current exchange rate at the date of purchase was 5.19.

(Note.—The London Company should show, parenthetically in the fixed asset accounts, the dollar cost of the plant, converted at the rate current at the date of making the expenditure.)

Plant (\$36,330.00)	£ 7,000	
Cash.....		£ 7,000

- (3) The United States Company shipped goods to the subsidiary, billing the subsidiary at the cost of the goods, \$134,680.00.

(Note.—The invoices were made out in dollars and are payable in dollars. The rate at the date of arrival was 5.20. Hence the London Company took up the goods at £25,900, showing the dollar liability short in the United States Company Current account.)

London Co. Current..... \$134,680 Sales to London Co.... \$134,680	Purchases..... £25,900 U.S. Co. Current (\$134,680.00).... £25,900
---	---

- (4) Sales on account by London Company, £21,000.

Accounts Receivable.....	£21,000	
Sales.....		£21,000

- (5) Collections on account by London Company, £19,000.

Cash.....	£19,000	
Accounts Receivable....		£19,000

- (6) The London Company paid half of its indebtedness to the United States Company (on current account for purchases) by sending a draft for \$67,340.00 (\$134,680.00 ÷ 2). The cost of this draft at 5.18 was £13,000 (\$67,340.00 ÷ 5.18).

(Note.—The total liability of the London Company for purchases, stated in pounds, was £25,900. Half of this amount is £12,950. Since the draft cost £13,000, the foreign subsidiary incurred an exchange loss of £50. The foreign company might have a cash book column for such exchange losses and gains, but entries in a cash book with such a column would be equivalent to the journal entry shown on the following page.)

FOREIGN EXCHANGE

Cash.....	\$67,340	U.S. Co. Current	
London Co.		(\$67,340.00)....	£12,950
Current	\$67,340	Exchange	50
		Cash.....	£13,000

(7) The London Company paid expenses of £2,000.

Expense	£ 2,000
Cash.....	£ 2,000

(8) The London Company provided depreciation at 4% on its plant.

Depreciation.....	£ 280
Res. for Dep'n.	£ 280

(9) The London Company paid a dividend of £2,000 to the United States Company. The United States Company sold the draft at 5.19, receiving \$10,380.00.

Cash.....	\$10,380	Dividend.....	£ 2,000
Investment in		Cash.....	£ 2,000
London Co..	\$10,380		

Subsidiary's trial balance and closing.—Following are the trial balance and the closing entries of the London Company at the end of the year. The dollar balances of accounts kept in both currencies are shown in parentheses.

Cash.....	£ 5,000	
Accounts Receivable	2,000	
U. S. Co. Current (\$67,340.00).....		£ 12,950
Plant (\$36,330.00).....	7,000	
Reserve for Depreciation		280
Capital Stock (\$52,000.00).....		10,000
Sales.....		21,000
Purchases.....	25,900	
Expense.....	2,000	
Depreciation.....	280	
Exchange.....	50	
Dividend.....	2,000	
	<u>£ 44,230</u>	<u>£ 44,230</u>

Inventory, December 31: £ 10,000.

Closing Entries

Profit and Loss.....	£ 28,230	
Purchases.....		£ 25,900
Expense.....		2,000
Depreciation.....		280
Exchange.....		50
Inventory.....	10,000	
Sales.....	21,000	
Profit and Loss.....		31,000

Profit and Loss.....	£2,770	
Surplus.....		£2,770
Surplus.....	2,000	
Dividend.....		2,000

Parent company's conversion.—Following are the trial balance, profit and loss statement, and surplus statement both in pounds and in dollars as converted by the parent company.

	Trial Balance			
	Pounds	Rate	Dollars	
Cash.....	5,000	B	25,925.00	
Accounts Receivable.....	2,000	B	10,370.00	
U. S. Co. Current	12,950	A		67,340.00
Plant.....	7,000	A	36,330.00	
Reserve for Depreciation (4%)	280	F		1,453.20
Capital Stock.....	10,000	A		52,000.00
Sales.....	21,000	C		108,990.00
Purchases.....	25,900	D	134,680.00	
Expense.....	2,000	C	10,380.00	
Depreciation.....	280	F	1,453.20	
Exchange.....	50	C		259.50
Dividend.....	2,000	E	10,380.00	
	<u>44,230</u>	<u>44,230</u>	<u>229,777.70</u>	<u>229,783.20</u>
Exchange Adjustment			5.50	
			<u>229,783.20</u>	<u>229,783.20</u>

Inventory: £10,000 @ 5.185, \$51,850.00.

Explanation of conversions:

- A* = Dollar balance shown in dollar memorandum column on London Company books.
- B* = Current rate on December 31: 5.185.
- C* = Average rate for year: 5.19.
- D* = Balance of reciprocal account (Sales to London Company) on United States Company books.
- E* = Amount credited to Investment account on United States Company books.
- F* = At 4% of gross dollar value of plant.

LONDON COMPANY

Balance Sheet, December 31, 193-

Assets		Liabilities and Net Worth	
Cash.....	£ 5,000 \$ 25,925.00	U. S. Co. Cur-	
Accts. Rec....	2,000 10,370.00	rent.....	£12,950 \$ 67,340.00
Inventory.....	10,000 51,850.00	Capital Stock.	10,000 52,000.00
Plant Less De-		Surplus.....	770 3,681.80
preciation...	6,720 34,876.80		
	<u>£23,720</u> <u>\$123,021.80</u>		<u>£23,720</u> <u>\$123,021.80</u>

FOREIGN EXCHANGE

LONDON COMPANY
Profit and Loss Statement
Year Ended December 31, 193-

	Pounds	Dollars
Sales.....	21,000	108,990.00
Less Cost of Goods Sold:		
Purchases.....	25,900	134,680.00
Less Inventory, December 31..	10,000	15,900
	5,100	51,850.00
Gross Profit on Sales.....		82,830.00
Deduct:		26,160.00
Expenses.....	2,000	10,880.00
Depreciation..	280	2,280
	2,820	1,453.20
Net Profit on Operations.....		11,833.20
Exchange Loss.....	50	259.50
Net Profit.....	2,770	14,067.30

LONDON COMPANY
Surplus Statement
Year Ended December 31, 193-

Profits for the Year.....	£ 2,770	\$14,067.30
Less Dividends.....	2,000	10,380.00
Balance, December 31.....	£ 770	\$ 3,687.30
Less Exchange Adjustment—required to make the Capital Stock and Surplus in dollars equal to the converted value of the London subsidiary's net assets.....		5.50
Adjusted Balance of Surplus.....		\$ 3,681.80

Parent company's closing.—Following are the trial balance and closing entries of the parent company:

UNITED STATES COMPANY
Trial Balance
December 31, 193-

Cash.....	\$ 17,720.00	
Accounts Receivable.....	10,000.00	
London Company Current.....	67,340.00	
Investment in London Company.....	41,620.00	
Plant.....	60,000.00	
Reserve for Depreciation.....		\$ 3,000.00
Accounts Payable.....		9,000.00
Capital Stock.....		150,000.00
Sales.....		200,000.00
Sales to London Company.....		134,680.00
Material Purchases.....	100,000.00	
Direct Labor.....	90,000.00	
Manufacturing Expense.....	85,000.00	
Depreciation.....	3,000.00	
Expense.....	22,000.00	
	\$496,680.00	\$496,680.00

FOREIGN EXCHANGE

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Inventories, December 31:

Raw Materials.....	\$6,000.00
Goods in Process.....	3,000.00
Finished Goods.....	5,000.00

Closing Entries

Raw Materials Inventory.....	\$ 6,000.00	
Material Purchases.....		\$ 6,000.00
Manufacturing Account.....	272,000.00	
Material Purchases.....		94,000.00
Direct Labor.....		90,000.00
Manufacturing Expense.....		85,000.00
Depreciation.....		3,000.00
Goods in Process Inventory.....	3,000.00	
Manufacturing Account.....		3,000.00
Finished Goods.....	269,000.00	
Manufacturing Account.....		269,000.00
Sales to London Company.....	134,680.00	
Finished Goods.....		134,680.00
Profit and Loss.....	129,320.00	
Finished Goods.....		129,320.00
Cost of goods sold:		
Cost of goods manufactured....	\$269,000.00	
Less: Shipments to		
London... ..	\$134,680.00	
Inventory.. ..	5,000.00	
	<u>139,680.00</u>	
	<u>\$129,320.00</u>	
Sales.....	200,000.00	
Profit and Loss.....		200,000.00
Profit and Loss.....	22,000.00	
Expense.....		22,000.00
Investment in London Company.....	14,067.30	
Profit and Loss.....		14,067.30
To take up subsidiary net profit per profit and loss statement as converted.		
Profit and Loss.....	5.50	
Investment in London Company.....		5.50
To record exchange adjustment and to bring the investment account into agreement with the London net assets.		
Profit and Loss.....	62,741.80	
Surplus.....		62,741.80
U.S. profit.....	\$ 48,680.00	
London profit.....	14,067.30	
Total.....	<u>\$ 62,747.30</u>	
Less exchange.....	5.50	
Net profit.....	<u>\$ 62,741.80</u>	

Parent company's investment account.—Following is a statement of the parent company's account with its investment in the London subsidiary after the foregoing entries have been posted.

Statement of Account		
Investment in London Company		
Year Ended December 31, 193-		
Cost.....		\$52,000 00
Add Profit.....		<u>14,067.30</u>
Total.....		\$66,067.30
Deduct:		
Dividend.....	\$10,380 00	
Exchange Adjustment.....	<u>5 50</u>	<u>10,385 50</u>
Balance, December 31, 193-.....		<u>\$55,681.80</u>

Consolidated statements.—The consolidated profit and loss statement of the parent company and its foreign subsidiary, and the consolidated balance sheet working papers, appear on pages 463 and 464.

UNITED STATES COMPANY AND LONDON SUBSIDIARY

Consolidated Statement of Profit and Loss
For the Year Ended December 31, 193-

	U.S. Company	London Company	Consolidated
Sales.....	\$200,000.00	\$108,990.00	\$308,990.00
Cost of Sales:			
Materials:			
Purchases.....	\$100,000.00		\$100,000.00
Less Inventory, December 31.....	6,000.00		6,000.00
Materials Used.....	\$ 94,000.00		\$ 94,000.00
Direct Labor.....	90,000.00		90,000.00
Manufacturing Expense, Including Depreciation..	88,000.00		88,000.00
Total Manufacturing Cost.....	\$272,000.00		\$272,000.00
Less Goods in Process, December 31.....	3,000.00		3,000.00
Cost of Goods Manufactured.....	\$269,000.00		\$269,000.00
Goods Shipped to London.....	134,680.00	\$134,680.00	
Remainder.....	\$134,320.00		
Less Inventory, December 31.....	5,000.00	51,850.00	50,850.00
Cost of Sales.....	129,320.00	82,830.00	212,150.00
Gross Profit on Sales.....	\$ 70,680.00	\$ 26,160.00	\$ 96,840.00
Expenses, Including Depreciation.....	22,000.00	11,833.20	33,833.20
Net Profit on Operations.....	\$ 48,680.00	\$ 14,326.80	\$ 63,006.80
Exchange Loss (\$259.50 + \$5.50).....		265.00	265.00
Net Profit for the Year.....	\$ 48,680.00	\$ 14,061.80	\$ 62,741.80

UNITED STATES COMPANY AND LONDON SUBSIDIARY
Consolidated Balance Sheet Working Papers
December 31, 193-

	U.S. Company	London Company	Eliminations	Consolidated Balance Sheet
Assets				
Cash.....	\$ 17,720.00	\$ 25,925.00		\$ 43,645.00
Accounts Receivable.....	10,000.00	10,370.00		20,370.00
London Company Current.....	67,340.00		\$ 67,340.00(A)	
Raw Materials.....	6,000.00			6,000.00
Goods in Process.....	3,000.00			3,000.00
Finished Goods.....	5,000.00	51,850.00		56,850.00
Investment in London Company.....	55,681.80		55,681.80(B)	
Plant Less Depreciation.....	57,000.00	34,876.80		91,876.80
	\$221,741.80	\$123,021.80	\$123,021.80	\$221,741.80
Liabilities and Net Worth				
Accounts Payable.....	\$ 9,000.00			\$ 9,000.00
United States Company Current.....		\$ 67,340.00	\$ 67,340.00(A)	
Capital Stock.....	150,000.00	52,000.00	52,000.00(B)	150,000.00
Surplus:				
United States Company.....	62,741.80			62,741.80
London Company.....		3,681.80	3,681.80(B)	
	\$221,741.80	\$123,021.80	\$123,021.80	\$221,741.80

CHAPTER 55

ESTATES AND TRUSTS

Distribution of an estate.—If a person dies intestate—that is to say, without leaving a will—his estate will be distributed among his heirs in accordance with the laws of descent and distribution, the laws of descent determining the disposition of the real estate, and the laws of distribution determining the disposition of the personal property. The disposition of the property is controlled by the probate, or surrogate, court, and the work of collecting the assets, paying the liabilities, and distributing the surplus is placed by the court in the hands of an administrator who is appointed by the court and to whom the court issues letters of administration, evidencing his authority.

If the decedent leaves a valid will, the laws of descent and distribution will not be operative, and the estate will be disposed of in accordance with the wishes of the testator or testatrix as expressed in the will.* But before the will can become operative, it must be admitted to probate. A petition is presented to the court, asking that the will be admitted to probate; a date is set for the hearing, and all interested parties are notified. At the hearing, the witnesses to the will testify as to the authenticity of the signatures; if the witnesses are dead or cannot appear, persons familiar with the signatures of the testator and the witnesses may testify as to the authenticity of the signatures; and if the court is satisfied that the will is valid, it is admitted to probate.

If an executor is named in the will, and if he is competent and willing to serve, he will be granted letters testamentary by the court. If no executor is named in the will, or if one is named but is unwilling or incompetent to serve, the court will appoint an administrator.

* This statement is subject to such exceptions as the widow's option to renounce her rights under the will and claim her distributive share under the law.

Duties of the executor or the administrator.—The executor or the administrator is expected to seek out and take possession of the personal property of the decedent, conserve the estate in a prudent manner, pay the liabilities, the Federal estate and income taxes, and the state inheritance and personal property taxes, and distribute the residue of the estate to the heirs or beneficiaries named in the will. If there is no will, the administrator disposes of the property to those who are heirs in accordance with the law. If there is a will, the real estate goes to the devisees, and the personal property to the legatees.

The title to all personal property vests in the executor or the administrator, and passes through him to the heirs or the legatees. It is only rarely that the executor or the administrator exercises any control over the real estate, since, by the laws of most states, title vests in the heirs or the devisees immediately upon the death of the decedent. If, however, the personal property is not sufficient to pay the debts of the estate, the executor may apply to the court for authority to sell parcels of real estate. Or the will may direct the executor to sell real estate to pay debts or to obtain money with which to create a trust. Or the testator may have made a contract to sell real estate; in such cases the title to the real estate passes to the heir, but subject to the obligation of the heir to convey title to the vendee; and since the claim against the vendee is personal property, this property passes into the executor's control.

The proceeds of life insurance policies payable to the estate pass through the hands of the executor and must be accounted for by him; the proceeds of policies payable to specific beneficiaries are payable directly to them and do not go to the executor.

Accounting for assets.—As soon as the executor or the administrator* is appointed, he should take possession of the personal property. While the law differs in the various states, it is desirable, and in some states obligatory, to file an inventory of the assets with the court. This inventory should show

* Since the duties of an executor and an administrator are similar, we may hereafter refer to either as inclusive of both.

items and values; the values may be estimated by the executor unless the law requires that the valuations be made by independent appraisers.

The inventory should include all personal property of the estate, including advances to heirs or legatees made by the decedent during his life with the understanding that these advances shall be considered a part of his estate. If the will relieves the recipients of such advances from the obligation of repaying them, they need not be included in the inventory. Income accrued up to and including the date of death is a part of the principal of the estate and should be included in the inventory. If any assets are thought to be valueless, they should, nevertheless, be included in the inventory with a statement that they have no value.

Although real estate titles pass directly to heirs without passing through the administrator, or directly to devisees without passing through the executor, it is nevertheless advisable that real estate be inventoried, in order to fulfill the requirements of state inheritance tax laws and the Federal estate tax law. Moreover, in some states the real estate must be included in the inventory, because the inventory, filed with the county recorder, serves as evidence of the passing of title.

When the inventory is completed, it should be made the basis of the opening entry on the executor's books. Enough asset accounts should be opened to classify the property in the records, and these accounts should be debited with the inventory values; the offsetting credit should be made to an account called Estate Corpus or Estate Principal.

Any assets discovered after the inventory is completed should be reported in a supplemental inventory and put on the books by entries debiting asset accounts and crediting an account called Assets Not Inventoried. This account is really a part of the Estate Corpus account, but it is desirable to set up the separate account because the executor, in making his report to the court, should show under separate headings the assets originally inventoried and those subsequently discovered. The Assets Not Inventoried account will eventually be closed to the Estate Corpus account.

When an asset is sold, the asset account should be credited with the inventory value, regardless of the price realized.

Gains should be credited to a Gain on Realization account, and losses should be charged to a Loss on Realization account. These accounts will eventually be closed to the Estate Corpus account; they are set up temporarily to furnish the information about gains and losses which will be required in making the report to the court. Such losses and gains may be recorded through the journal, or special columns may be provided on the receipts side of the cash book.

Accounting for liabilities.—In some states it is obligatory, and in all states it is advisable, for the executor to give published notice to creditors to present their claims within the legal time limit. Claims will be presented to the executor or to the court, depending on the law of the state; presentation is usually made to the executor. The executor should present a statement to the court showing the claims filed. Any claims which the executor considers invalid he may reject. In some states creditors whose claims have been rejected may appeal to the probate court; in other states they must bring suit in the ordinary manner.

The debts must be paid in full before legacies can be paid. If the personal property is not sufficient to pay the debts and the legacies, the legacies will be abated—that is, scaled down. Such provisions for the payment of debts will be made in the following order:

- (1) Residuary legacies (including any real estate forming part of the residuary estate) will be abated. Thereafter,
- (2) General legacies, payable in cash, will be scaled down proportionately. If these are exhausted,
- (3) Any personal property or real estate specifically willed to a legatee or a devisee will be sold.

Liabilities should not be recorded until paid, at which time an entry should be made debiting Debts of Decedent and crediting Cash. One account for debts is sufficient, but the payee should be named in the Explanation column of the account.

Expenses and debts incurred subsequent to the death of the decedent should be divided into two classes: those that are chargeable to the principal, which may be debited to an

account called Funeral and Administration Expense; and those that are chargeable to income, which should be debited to an account called Expense—Income. The rules for distinguishing between these two classes of expenses are discussed later in this chapter. If the estate is a large one, both the Funeral and Administration Expense account and the Expense—Income account may be subdivided.

Accounting for legacies.—A legacy is a gift of personal property made by a will; the recipient of a legacy is called a legatee. A devise is a gift of real property made by a will; the recipient of the gift is called a devisee.

A general legacy is one payable out of the estate in general; the legatee may, with the sanction of the executor, take personal property of the estate to the value of the legacy, or he may be paid in cash.

A specific legacy is a gift of some particular property, as a watch, a library, or named bonds.

A demonstrative legacy is a legacy of cash payable out of a specified fund.

A residuary legacy includes all personal property remaining after the payment of debts and all other legacies. The residuary legatee receives "all the rest, residue, and remainder" of the estate.

Legacies may be paid at any time after the executor takes charge; but unless the estate is clearly sufficient to pay the legacies, taxes, and debts, the executor should defer the payment of legacies until the period for filing claims has expired; otherwise he may incur a personal liability to creditors. The law usually allows the executor the right to defer the payment of legacies for a year, in order to determine the amount of the liabilities. Any income earned on specific legacies during that time belongs to the legatee. Interest on all unpaid legacies begins to accrue at the end of one year from the date of death.

A single account may be opened with Legacies Paid, or a separate account may be opened with each legacy. Separate accounts are desirable if (1) inheritance taxes are to be charged against the legacies, (2) legacies are to be abated in order to pay debts, or (3) income is earned on specific legacies before they are paid. Entries in these accounts are made as follows:

Legacy—John Doe

Cash

Payment of inheritance tax.

Cash

Legacy—John Doe

Income collected on bonds willed to Doe.

Cash

John Doe—Legacy

Refund from Doe for inheritance tax paid, less income collected.

John Doe—Legacy

Bonds of X Q Company

Payment of legacy to Doe.

The will may stipulate that the total inheritance tax shall be paid by the estate, thus reducing only the residuary legacy.

The legacy accounts will remain open until after the final statement has been made up for presentation to the court; they will then be closed into the Estate Corpus account.

Trusts.—The testator may provide in his will that all, or some portion, of the principal of the estate shall be placed in the hands of a trustee, who shall keep the fund invested, distribute the income to certain beneficiaries during a stated period of time, and eventually turn over the principal of the trust to some beneficiary indicated by the will. For instance, he may direct that the income shall be paid to his widow during her life, and that, at her death, the principal shall be paid to his children or to some institution. Or he may direct that the income shall be distributed in equal parts to his children until the youngest one reaches the age of twenty-five, and that the principal shall then be divided equally among them.

A trust created by a will is called a testamentary trust. If the trustee is named in the will, he is called a testamentary trustee. The person who is entitled to receive the income during a stated period, and the person who is entitled eventually to receive the principal, or corpus, are beneficiaries of the trust. The income beneficiary is called the *cestui que trust*. The *cestui que trust* is called a life tenant if he is entitled to the income during the entire period of his life; if he is entitled to the income for a shorter period, he may be referred to merely as the income beneficiary; if the income beneficiary changes from time to time, each beneficiary

may be referred to successively as the present beneficiary. The person who is entitled eventually to receive the principal of the trust is called the remainderman. The *cestui que trust* and the remainderman may be the same person; for instance, a child may be entitled to the income of the trust until he attains his majority, and to the corpus of the trust at that date.

The executor should turn over the trust property to the trustee and record the transfer in the same way that legacies are recorded. The same person may act as executor or administrator and also as trustee, but in such instances his executorship records should be kept entirely distinct from his trusteeship records. The executorship records should show that the executor, as such, has turned certain property over to himself as trustee; and the trusteeship records should show that the trustee, as such, has received the property from himself as executor.

The trustee does not take over the duties of the trusteeship until the trust property is turned over to him. He takes title to real estate at the date of the testator's death, but personal property may not be turned over to him by the executor until some subsequent date. However, the trust takes effect as of the date of death; therefore the life tenant is entitled to the income from the trust assets from the date of death.

The trustee's investments must conform to the state laws which prescribe what classes of securities may be purchased by trustees, but the testator may, in the will, allow the trustee to go beyond the narrow limits allowed by law. The trustee must exercise diligence and prudence in managing the trust and must keep the funds invested. He is allowed a reasonable time in which to invest cash, after which time he may be charged with interest on uninvested funds.

The trustee's accounts are less involved than those of an executor, because a trustee does not have assets to realize, liabilities to pay, and legacies to distribute. Accounts should be kept with all assets of the trust, which should be offset by a Trust Principal account. Accounts should also be kept with the various kinds of income and expenses. The net income thus determined should be transferred to an account with the life tenant, by charging the income accounts, credit-

ing the expense accounts, and crediting the life tenant's account. Payments to the life tenant should be charged to his account.

Accounting for income and expense.—All of the income of a small estate or trust may be credited to a single account called Income; but in a large estate it is preferable to open separate accounts with the various classes of income, such as Interest Income, Dividend Income, and Rent Income.

All expenses deductible from the income may be charged to one account called Expense—Income; or separate accounts may be kept with the various kinds of expense.

If cash collected as income is paid to beneficiaries, the charges should be made to an account called Distributions of Income Cash.

Principal and income.—If a trust is created by the will, the executor and the trustee should keep their records in such a way as to distinguish clearly between the principal and the income. The life tenant is entitled to the income, and the remainderman is entitled to the principal. Therefore, if cash is received, the executor or trustee must know, and must indicate in his records, whether the cash belongs in the principal fund or in the income fund. Similarly, a careful distinction must be made between disbursements which are payable out of principal and those which are payable out of income.

A strict distinction between principal and income *must* be maintained in trust accounting, and is customarily maintained in all estate accounting regardless of whether or not a trust is involved.

If the will makes any statements which can be interpreted as indicating the desire of the testator regarding the distinctions to be made between principal and income, these statements will govern. In the absence of any such expressions of intention, the law will govern. In questionable cases the trustee should apply to the court for a ruling.

The questions involving a distinction between principal and income may be classified as follows:

- (1) Questions of accrual or apportionment on a time basis; that is, in what cases should cash received go

partly into principal cash and partly into income cash; and in what cases should cash payments be made partly out of principal cash and partly out of income cash?

- (2) Questions of classification; that is, what receipts should go wholly into principal cash or wholly into income cash; and what payments should be made wholly out of principal cash or wholly out of income cash?
- (3) Questions of impairment; that is, in what cases should a portion of the cash received go into the principal cash to prevent an impairment of the principal?

Questions of accrual.—The distinction between a cash basis and an accrual basis of accounting is well understood as applied to ordinary commercial accounts. The law of trust estates provides that certain items of income and expense “accrue” and shall be accounted for on an accrual basis, and that others shall be accounted for on a cash basis. If an item of income or expense accrues, a proper computation of the interests of the life tenant and the remainderman requires a recognition of the accrual at two dates.

First, there is the date of the death of the testator. Any income which has accrued prior to that date belongs to the corpus of the estate, even though it may not be collected until a subsequent date; income subsequently accruing belongs to the life tenant. Similarly, expenses accrued prior to this date must be paid out of principal cash, whereas expenses accruing subsequently must be paid out of income cash.

Second, there is the date when the tenancy terminates and the remainderman receives the corpus. Income accrued prior to that date belongs to the life tenant or to his estate; income accrued subsequently belongs to the remainderman. A similar distinction must be made in regard to expenses.

The question then is: What earnings and expenses accrue and have to be apportioned between principal and income?

- (1) Interest, in general, accrues from day to day, the interest accrued on receivables and investments up to and including the date of death of the testator being principal, and interest accruing thereafter being income. Interest paid as an expense is

similarly accrued. But interest on savings bank deposits usually is not considered to accrue, because of the requirement that the deposit shall remain a stipulated time. Such interest is income of the period when it is credited to the account.

- (2) Ordinary cash dividends do not accrue, but are generally considered income of the period when declared. Thus, a dividend declared prior to the testator's death is corpus, even though not collected until after his death; and a dividend declared after his death is income, although paid from profits earned prior to his death. In some states the governing date is that on which the corporation's stock records are closed to determine the "stockholders of record" to whom the dividends are payable. The rule is not so simple in the case of extraordinary cash dividends and stock dividends, the laws differing in the various states.
- (3) Rents, whether income or expense, accrue in most states, although not in all. In the states in which they do accrue, rents earned prior to the death of the decedent are corpus, and the portion accruing after his death is income. A similar rule applies to rents paid.
- (4) Property taxes do not accrue. Taxes which became a lien on the property before the date of the decedent's death are payable out of principal cash; taxes which became a lien on the property after his death are a charge against income.
- (5) Partnership profits do not accrue. The death of the testator dissolves the partnership of which he was a member; and if the books are closed as of the date of his death, the question of accrual will not arise, for all of the profits earned up to the date of death are clearly principal. But the partnership articles sometimes provide that the books shall not be closed until some date subsequent to death; in such cases the profit up to the date of closing the books is considered to be principal even though some of the profit may have been earned after the decedent's death. There is one exception to this rule: If

interest is allowed on a partner's capital, it accrues in accordance with the general interest rule.

- (6) Contract profits do not accrue. The executor must complete the contract, but the profits belong to the principal.
- (7) Live stock born after the date of the testator's death is income.
- (8) Growing crops are income if the land is part of a trust estate, and no attempt need be made to apportion the value of the first crop between principal and income. If the land is given as a devise, the crops go with the land.

Questions of classification.—There are many items of receipts and disbursements which do not involve the question of accrual and apportionment on a time basis, but which involve the equally important question of determining whether the whole amount should be classified as principal or income. These items may be classified as:

- (1) Receipts and disbursements applicable to principal.
- (2) Receipts and disbursements applicable to income.
- (3) Receipts and disbursements of doubtful classification.

Items applicable to principal.—The following expenditures should be charged to principal and paid out of principal cash:

- (1) Debts of the decedent, expenses of last illness, and funeral expenses.
- (2) Legal fees and court costs in probating the will, in defending it against a contest, and in interpreting it.
- (3) Costs of defending the estate against claims rejected by the executor.
- (4) Legal fees incurred in effecting a change in executors or trustees.
- (5) Federal estate tax and state inheritance tax.
- (6) Brokerage fees on changes in investments.
- (7) Legal fees and other costs of preserving the principal of the estate.

The following receipts should be credited to principal:

- (1) Proceeds of fire insurance policies. The premiums are

payable out of income, but in case of loss the proceeds of the policy are considered to be a replacement of the principal.

- (2) The proceeds of the sale of subscription rights. The right to subscribe for stock is inherent in the stock, which is corpus; hence all receipts from the sale of subscription rights are principal.

Items applicable to income.—All ordinary operating expenses of the estate or the trust are payable out of income. These include such items as:

- (1) Commissions paid for collection of income.
- (2) Legal fees paid in matters pertaining to income as distinguished from matters pertaining to the preservation of the estate.
- (3) Wages of clerks, bookkeepers, and workmen employed to care for the property.
- (4) Costs of caring for and harvesting crops.
- (5) Trustee's commissions for collection and disbursement of income.
- (6) Ordinary repairs to trust property.
- (7) Interest accrued during the life tenancy on mortgages and other liabilities.
- (8) Insurance premiums.

Doubtful items.—The rule as to ordinary cash dividends has already been stated: Dividends declared prior to the decedent's death are principal, and those declared after his death are income. The rule as to stock dividends and extraordinary cash dividends is not so clear. In some states both have been held to be principal; in other states both have been held to be income; and in still other states an attempt has been made to allocate the dividends, the portion paid from surplus existing at the testator's death being considered principal, and the portion paid from earnings since his death being considered income.

Repairs and betterments are classified in accordance with the usual accounting rule: Ordinary repairs are chargeable to income; extraordinary repairs to principal; replacements and betterments may be apportioned, the portion making good wear and tear during the period of the trust being charged to

income, and the balance to principal. While the rule is not difficult to state, it is often very difficult to apply.

Special assessments for local benefits may be paid out of principal, if the benefits are expected to add permanent value; otherwise, they should be paid out of income. In some cases a portion may be paid from principal, and the remainder from income.

Unless the will creating the trust gives specific instructions applicable to doubtful cases, the trustee should apply to the court for instructions.

Questions of impairment.—There is a general rule that payments of income must not impair the principal of a trust. Thus, if the trust property consists of mines, oil wells, timber, or other wasting assets, the trustee must provide for depletion when computing income, and must retain such a portion of the receipts from operations as will provide a fund for the replacement of the trust property.

Similarly, if the trust investments consist of stocks in a company operating a wasting asset, dividends will usually include both profits and a return of capital. The trustee must attempt to separate these two elements, paying the life tenant only such a portion of the dividend as represents earnings, and holding for the remainderman such a portion of the dividend as represents a return of capital.

The rule for depreciation is different. Ordinary repairs on fixed assets must be made out of income, but depreciation may be ignored in computing income, and it is not necessary to retain cash out of income to create a depreciation or a replacement fund.

Any losses or gains on the realization of assets are generally considered to be applicable to principal, for the loss or gain is merely the difference between the estimated or inventory value and the actual realized value. The principal of the estate is composed of the assets left by the decedent, or whatever these assets realize.

In accordance with this general theory, if bonds left by the decedent are inventoried at a premium, turned over to a trustee, and held by him until maturity, there will be a book loss of the difference between the inventory value and par. But this loss is to be borne by principal, for the principal is

not considered to be impaired if it contains the actual assets left by the decedent, or the proceeds of these assets.

But, contrary to the general theory of charging losses to principal, if the trustee purchases bonds at a premium, the premium should be amortized, and the life tenant should receive income equal to the coupons minus the amortization. In other words, the whole amount paid by the trustee as premium will be taken out of the interest collections, and the life tenant will receive the balance.

Accounting for cash.—The executor should keep his records in such a manner as to distinguish between principal cash and income cash. This is easily accomplished by using a three-column cash book, as follows:

	<u>Receipts</u>		
	<u>Principal</u>	<u>Income</u>	<u>Total</u>
Cash per inventory.....	\$10,000.00		\$10,000.00
Interest on bonds.....	100.00	\$200.00	300.00
	<u>Payments</u>		
	<u>Principal</u>	<u>Income</u>	<u>Total</u>
Debts of Decedent.....	\$ 300.00		\$ 300.00
Expense—Income.....		\$ 35.00	35.00
Distributions of Income Cash.....		100.00	100.00

The balance of the Total columns shows the total cash in bank or on hand. The balances of the Principal and Income columns show how much of the cash belongs to the principal of the estate and how much belongs to income.

Illustration of Estate Accounting

George Henderson died on March 31, 1933, leaving a will in which he named W. C. Turner as executor and trustee without bond, and in which he disposed of his property as follows:

Home and household furniture, and \$10,000.00 in cash, to his widow.

Bonds of X Y Company, amounting to \$1,000.00, to W. C. Turner, in lieu of fees as executor and trustee.

All of the remaining property in trust, the income to be paid to his widow during her life, and at her death the principal to be paid to the Carmody Foundation.

The executor was directed to dispose of the testator's summer home, and to add the proceeds of the sale to the trust fund.

<u>Entries*</u>	<u>Dates</u>	<u>Events</u>	
	April 10—	The will was admitted to probate, and letters testamentary were issued to W. C. Turner.	
J. 1 } C.R. 1 }	April 15—	The executor filed the following inventory with the court:	
		Real Estate—Home	\$15,000 00
		Household Furniture	3,000.00
		Summer Home	5,000.00
		X Y Co. Bonds, 6%, F. & A.	1,000.00
		Accrued Interest	10.00
		Stock of P Q Co.—100 shares	10,000.00
		Dividends declared March 10, payable April 30	600.00
		S T Bonds, 6%, F. & A.	25,000 00
		Accrued Interest	250.00
		Automobile	1,500 00
		Insurance Policies payable to Estate	20,000 00
		Cash	700 00
			\$82,060.00
C.R. 2	April 16—	The executor collected the \$20,000.00 life insurance policies.	
J. 2	“ 17—	The executor turned over the home and household furniture to the widow as a legacy.	
C.D. 1	“ 18—	Paid funeral expenses, \$300.00.	
C.D. 2, 3	“ 30—	The executor purchased \$5,000.00 L M Company 6% bonds, F. & A., with \$75.00 accrued interest.	
C.R. 3	“ 30—	Collected \$600.00 dividends on P Q Company stock.	
C.D. 4	May 1—	Paid a \$10,000.00 cash legacy to the widow.	
C.R. 4 } J. 3 }	“ 5—	Sold the automobile for \$1,200.00.	
C.R. 5	“ 10—	Discovered a savings bank account with a balance of \$450.00. Withdrew this balance and deposited it in the checking account.	
C.D. 5	“ 15—	Paid taxes assessed prior to decedent's death, \$260.00.	
C.R. 6, 7	Aug. 1—	Collected \$30.00 interest on X Y Company bonds. The \$10.00 accrued interest at the testator's death is corpus, and since these bonds are a specific legacy, the \$20.00 accrued since is a part of the legacy.	

* J., C.R., and C.D. refer to the journal (pages 480 and 482), cash receipt book (page 481), and cash disbursements book (page 481). The numbers refer to the entries in these books.

<u>Entries</u>	<u>Dates</u>	<u>Events</u>
C.R. 8	Aug. 1	—Collected \$750.00 interest on <i>S T</i> Company bonds.
C.R. 9	“ 1	—Collected \$150.00 interest on <i>L M</i> Company bonds.
C.D. 6	“ 5	—Paid \$500.00 to the widow out of income.
J. 4	Sept. 10	—Dividends of \$500.00 were declared on the <i>P Q</i> Company stock, payable November 5.
C.D. 7	“ 20	—Paid all liabilities filed against the estate, totaling \$3,100.00.
C.D. 8	“ 22	—Total administration expenses paid, \$235.00.
C.R. 10	Oct. 5	—Cash receipts from crops raised on summer home, \$250.00.
C.D. 9	“ 7	—Cash payments for expenses of raising crops, \$110.00.
C.R. 11 } J. 5 }	“ 15	—Sold the summer home for \$5,800.00.
J. 6 } C.D. 10 }	“ 20	—The executor took the <i>X Y</i> Company bonds and \$20.00 of the interest collected on August 1, in payment of his legacy.
J. 7	“ 31	—The executor recorded the accrued interest on the <i>S T</i> Company bonds, and the <i>L M</i> Company bonds preparatory to making his final report to the court as of this date.

The books were posted and a trial balance was taken. (The reader is advised to post the journal and cash book entries to skeleton ledger accounts, and compare the balances with the trial balance on page 482.)

Executor's Journal

(1) April 15	Real Estate—Home.....	15,000.00	
	Household Furniture.....	3,000.00	
	Real Estate—Summer Home.....	5,000.00	
	<i>X Y</i> Co. Bonds—F. & A.—6%.....	1,000.00	
	Accrued Interest Receivable.....	10.00	
	<i>P Q</i> Co. Stock.....	10,000.00	
	Dividends Receivable.....	600.00	
	<i>S T</i> Co. Bonds—F. & A.—6%.....	25,000.00	
	Accrued Interest Receivable.....	250.00	
	Automobile.....	1,500.00	
	Insurance Policies.....	20,000.00	
	Estate Corpus.....		81,360.00
	To spread the inventory on the books.		
(2) April 17	Legacy—Mary Henderson.....	18,000.00	
	Real Estate—Home.....		15,000.00
	Household Furniture.....		3,000.00
	Satisfaction of specific legacy.		

Executor's Cash Receipts

			Income	Principal	Total
(1)	April	15	Estate Corpus.....	700.00	700.00
(2)		16	Insurance Policies.....	20,000.00	20,000.00
(3)		30	Dividends Receivable.....	600.00	600.00
(4)	May	5	Automobile.....	1,200.00	1,200.00
(5)		10	Assets Not Inventoried.....	450.00	450.00
(6)	Aug.	1	Accrued Interest Receivable.....	10.00	10.00
(7)		1	Legacy—W. C. Turner.....	20.00	20.00
(8)		1	Interest on <i>S T Co.</i> Bonds*	250.00	250.00
(9)		5	Interest on <i>L M Co.</i> Bonds*	75.00	150.00
(10)	Oct.	5	Income.....	250.00	250.00
(11)		15	Summer Home.....	5,800.00	5,800.00
				<u>825.00</u>	<u>29,930.00</u>

Executor's Cash Disbursements

				Income	Principal	Total
(1)	April	18	Funeral and Administration Expense.....	300.00	300.00	
(2)		30	<i>L M Co.</i> Bonds.....	5,000.00	5,000.00	
(3)		30	Accrued Interest Receivable.....	75.00	75.00	
(4)	May	1	Legacy—Mary Henderson.....	10,000.00	10,000.00	
(5)		15	Debts of Decedent.....	260.00	260.00	
(6)	Aug.	5	Distributions of Income Cash.....	500.00	500.00	
(7)	Sept.	20	Debts of Decedent.....	3,100.00	3,100.00	
(8)		22	Funeral and Administration Expense.....	235.00	235.00	
(9)	Oct.	7	Expense—Income.....	110.00	110.00	
(10)		20	Legacy—W. C. Turner.....	20.00	20.00	
		31	Balance.....	215.00	10,115.00	
				<u>825.00</u>	<u>29,105.00</u>	
					<u>29,930.00</u>	

* Amounts in the Principal column should be posted to Accrued Interest Receivable; amounts in the Income column should be posted to Income Account.

(3) May 5	Loss on Realization.....	300.00	
	Automobile.....		300.00
	Sale of auto inventoried at \$1,500.00		
	Price received.....	1,200.00	
	Loss.....	<u>\$ 300.00</u>	
(4) Sept. 10	Dividends Receivable... ..	500.00	
	Income.....		500.00
	Dividends declared on <i>P Q</i> Co. stock, payable November 5.		
(5) Oct. 15	Summer Home.....	800.00	
	Gain on Realization.		800.00
	Home sold for.....	\$5,800.00	
	Inventoried at.....	<u>5,000.00</u>	
	Gain.....	<u>\$ 800.00</u>	
(6) Oct. 20	Legacy— <i>W. C. Turner</i>	1,000.00	
	<i>X Y</i> Co. Bonds		1,000.00
	Payment of specific legacy. See cash book entry for interest.		
(7) Oct. 31	Accrued Interest Receivable..	450.00	
	Income.....		450.00
	3 months' int. on <i>S T</i> bonds \$375.00		
	3 months' int. on <i>L M</i> bonds 75 00		

**Trial Balance
October 31, 1933**

(Before making report to court and before closing books)

Estate Corpus.....		\$82,060.00
Assets Not Inventoried.....		450.00
<i>P Q</i> Co. Stock.....	\$10,000.00	
<i>S T</i> Co. Bonds.....	25,000.00	
<i>L M</i> Co. Bonds.....	5,000.00	
Accrued Interest Receivable.....	450.00	
Dividends Receivable.....	500.00	
Loss on Realization.....	300.00	
Gain on Realization.....		800.00
Funeral and Administration Expense... .	535.00	
Debts of Decedent.....	3,360.00	
Legacy— <i>Mary Henderson</i>	28,000.00	
Legacy— <i>W. C. Turner</i>	1,000.00	
Income.....		1,775.00
Expense—Income.....	110.00	
Distributions of Income Cash.....	500.00	
Cash—Principal.....	10,115.00	
Cash—Income.....	215.00	
	<u>\$85,085.00</u>	<u>\$85,085.00</u>

Alternative procedure.—Some trust companies do not keep formal double entry records for each estate or trust.

Cash transactions are recorded in a Cash account for the estate or the trust, and securities and other assets are carried on a memorandum basis, without dollar values, until disposed of, when the proceeds are taken up in the Cash account. The report to the court is made from the Cash account and from the supplementary memorandum records as to assets not realized.

Trust companies following this procedure do not assign, in the inventory, any cash values to assets the ultimate realizable value of which cannot be exactly ascertained; consequently their records and reports do not show, as a gain or a loss, the difference between an inventory value and the proceeds ultimately realized.

CHAPTER 56

ESTATES AND TRUSTS (Concluded)

Charge and discharge statements.—The charge and discharge statement is a convenient form in which to report to a court the activities of an executor or a trustee. Two charge and discharge statements should be submitted—one as to income, and one as to principal.

Statement as to income.—The charge and discharge statement as to income will contain information as indicated below:

**ESTATE OF RICHARD ROE
JOHN DOE, EXECUTOR**

Charge and Discharge Statement as to Income

From (Date of Appointment) To (Date of Statement)

I CHARGE MYSELF WITH:

(List all income earned since the decedent's death, classified as interest, dividends, rents, etc. The total should agree with the balance of the Income account in the ledger.).....

\$.....

Total Charges.....

\$.....

I CREDIT MYSELF WITH:

(List all expenses chargeable to income.)..... \$.....

Payments of Income Cash to Beneficiaries. (List beneficiaries and amounts paid.).....

\$.....

Total Credits.....

\$.....

BALANCE.....

\$.....

If the statement is a final accounting, all of the net income will have been distributed, and the charges and credits will be equal.

Statement as to principal.—The charge and discharge statement as to principal will contain information of the nature indicated on the following page.

If the statement is made as a final accounting to the court, all of the assets should have been distributed. The asset accounts will have been closed out of the ledger, and the charges and credits in the statement will agree in totals, so

that there will be no balance in the charge and discharge statement.

**ESTATE OF RICHARD ROE
JOHN DOE, EXECUTOR**

**Charge and Discharge Statement as to Principal
From (Date of Appointment) To (Date of Statement)**

I CHARGE MYSELF WITH:

Assets per Inventory (Schedule A).....	\$.....
(The total of the assets listed in the inventory should agree with the credit balance of the Estate Corpus account.)	
Assets Subsequently Discovered (Schedule B).....	\$.....
(The total of this schedule should agree with the credit balance of the Assets Not Inventoried account.)	
Gain on Assets Realized (Schedule C).....	\$.....
(This schedule should describe the property sold, and should have four money columns to show inventory or appraised value, price realized, loss on realization, and gain on realization. The total of the gain column is the amount to insert at this place in the statement, and it should agree with the balance of the Gain on Realization account in the ledger.)	
Total Charges.....	\$.....
(This total shows the amount of the principal or corpus of the estate which has come into the executor's possession, and for which he must account. He accounts for the total as shown below.)	

I CREDIT MYSELF WITH:

Funeral and Administration Expense (Schedule D).....	\$.....
(This schedule will consist of an analysis of the account of the same title in the ledger.)	
Debts of Decedent Paid (Schedule E).....	\$.....
(This schedule will contain a list of debts paid, as shown by the ledger account.)	
Loss on Assets Realized (Schedule C).....	\$.....
(See explanation of this schedule above. The total will agree with the Loss on Realization column of Schedule C.)	
Payments of Legacies (Schedule F).....	\$.....
(This schedule should show total legacies, inheritance taxes paid thereon, if any, and payments to legatees.)	
	\$.....
Total Credits....	\$.....
BALANCE (Per Schedule G).....	\$.....
(This schedule should show the assets belonging to the corpus of the estate, still in the executor's possession, and should agree with the open asset accounts.)	

Cash account.—The report to the court should usually contain a statement of the Cash account, in three columns,

showing, with respect to both receipts and disbursements, the amounts applicable to principal, the amounts applicable to income, and the totals thereof.

Closing the books.—After the executor has paid all of the debts, distributed all of the assets, and made his final accounting to the court, his books may be closed. One set of closing entries should be made for the corpus, or principal, accounts, and another set of entries for the income accounts.

The entries as to principal accounts should be:

Assets Not Inventoried.....	\$.....	
Estate Corpus.....		\$.....
To credit the Corpus account with assets discovered after making the inventory. (The Estate Corpus account will thus be credited with the inventory and with the assets subsequently discovered.)		
Gain on Realization.....	\$.....	
Estate Corpus.....		\$.....
Estate Corpus.....	\$.....	
Loss on Realization.....		\$.....
(After these two entries have been made, the credit balance of the Corpus account will show the amount realized from the assets.)		
Estate Corpus.....	\$.....	
Debts of Decedent.....		\$.....
Estate Corpus.....	\$.....	
Funeral and Administrative Expense.....		\$.....
Estate Corpus.....	\$.....	
Legacy Accounts.....		\$.....

All of the accounts with the principal of the estate, including the Estate Corpus account, will now be closed. The accounts as to income are closed by the following entry:

Income.....	\$.....	
Expense—Income.....		\$.....
Distributions of Income Cash.....		\$.....
(This will close the Income accounts because all income collected must have been either paid out in expense or distributed to the beneficiaries.)		

If the termination of the estate involves the transfer of estate assets to a trustee, the closing entries will include entries debiting the trustee and crediting the transferred assets. Such entries are shown in the following illustration.

Illustration continued.—The following statements and closing entries are based upon the accounts of the estate of George Henderson. The transactions, books of original entry, and trial balance are shown in the preceding chapter.

Statements.—The report to the court will include a transcript or a summary of the cash book (see page 481) and the following exhibits and schedules:

ESTATE OF GEORGE HENDERSON
W. C. TURNER, EXECUTOR
Charge and Discharge Statement as to Principal
March 31, 1933 to October 31, 1933

I CHARGE MYSELF WITH:		
Assets per Inventory (Schedule A).....	\$82,060 00	
Assets Subsequently Discovered (Schedule B).....	450 00	
Gain on Realization (Schedule C).....	<u>800.00</u>	
Total.....		\$83,310.00
I CREDIT MYSELF WITH:		
Funeral and Administration Expense (Schedule D) \$	535.00	
Debts of Decedent Paid (Schedule E).....	3,360.00	
Losses on Assets Realized (Schedule C)	300.00	
Legacies Paid (Schedule F).....	<u>29,000.00</u>	
Total.....		<u>33,195.00</u>
BALANCE AS TO PRINCIPAL.....		<u>\$50,115.00</u>
Consisting of:		
<i>P Q</i> Co. Stock.....	\$10,000.00	
<i>S T</i> Co. Bonds	25,000.00	
<i>L M</i> Co. Bonds.....	5,000 00	
Cash.....	10,115.00	
Total.....	<u>\$50,115.00</u>	

Inventory of Assets	Schedule A
March 31, 1933	
Real Estate—Home.....	\$15,000.00
Household Furniture.....	3,000.00
Real Estate—Summer Home.....	5,000.00
<i>X Y</i> Co. Bonds—F. & A., 6%.....	1,000.00
Accrued Interest thereon.....	10.00
<i>P Q</i> Co. Stock.....	10,000.00
Dividends declared thereon.....	600.00
<i>S T</i> Co. Bonds—F. & A., 6%.....	25,000.00
Accrued Interest thereon.....	250.00
Automobile.....	1,500.00
Insurance Policies.....	20,000.00
Cash.....	<u>700.00</u>
	<u>\$82,060.00</u>

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		<u>Schedule B</u>
Assets Subsequently Discovered		
Savings Bank Account.....	\$ 450.00	<u>450.00</u>

			<u>Schedule C</u>
	Assets Realized		
	Inventory	Price	Loss on
	Values	Realized	Realization
			Gain on
			Realization
Summer Home.....	\$ 5,000.00	\$ 5,800.00	\$ 800.00
Accrued Interest on <i>X Y</i>			
Co. Bonds, March 31.....	10.00	10.00	
Dividends declared on <i>P Q</i>			
Co. Stock.....	600.00	600.00	
Accrued Interest on <i>S T</i>			
Co. Bonds, March 31.....	250.00	250.00	
Automobile.....	1,500.00	1,200.00	\$ 300.00
Insurance Policies.....	20,000.00	20,000.00	
Total.....	<u>\$27,360.00</u>	<u>\$27,860.00</u>	<u>\$ 800.00</u>

		<u>Schedule D</u>
Funeral and Administration Expense		
Funeral Expenses.....	\$ 300.00	
Administration Expenses.....	235.00	
Total.....	<u>\$ 535.00</u>	

		<u>Schedule E</u>
Debts of Decedent Paid		
Taxes Assessed Prior to Death.....	\$ 260.00	
Accounts Payable:		
John Jones.....	\$ 210.00	
Wm. Smith.....	115.00	
Frank Brown.....	<u>775.00</u>	1,100.00
Notes Payable:		
First State Bank.....	<u>2,000.00</u>	
Total.....	<u>\$ 3,360.00</u>	

		<u>Schedule F</u>
Legacies Paid		
Mary Henderson:		
Home.....	\$15,000.00	
Household Furniture.....	3,000.00	
Cash.....	<u>10,000.00</u>	\$28,000.00
W. C. Turner:		
<i>X Y</i> Co. Bonds.....	1,000.00	
(Interest earned since Mar. 31, \$10.00.)		
Total.....	<u>\$29,000.00</u>	

ESTATE OF GEORGE HENDERSON
W. C. TURNER, EXECUTOR
Charge and Discharge Statement as to Income
March 31, 1933 to October 31, 1933

I CHARGE MYSELF WITH:

Interest on <i>S T</i> Co. Bonds:			
Collected August 1.....	\$750 00		
Less Accrued at March 31.....	250 00	\$ 500.00	
Accrued from Aug. 1 to Oct. 31.....		375 00	\$ 875.00
Interest on <i>L M</i> Co. Bonds:			
Collected August 1.....	\$150 00		
Less Accrued at Purchase—April 30 . . .	75 00	\$ 75.00	
Accrued from Aug. 1 to Oct. 31.		75.00	150.00
Dividend on <i>P Q</i> Co. Stock:			
Declared but not collected.....			500.00
Crops from Summer Home.....			250 00
Total.....			<u>\$1,775 00</u>

I CREDIT MYSELF WITH:

Expenses of Raising Crops.....	\$ 110.00		
Distributions of Income Cash.....		500.00	610.00

BALANCE AS TO INCOME..... \$1,165 00

Consisting of:

Dividends Receivable:			
Declared on <i>P Q</i> Co. Stock.....	\$ 500.00		
Accrued Interest:			
On <i>S T</i> Co. Bonds.....	375.00		
On <i>L M</i> Co. Bonds.....	75 00		
Cash.....		215 00	
Total.....		<u>\$1,165 00</u>	

Closing the executor's books.—The executor's cash book contains the following balances:

Executor's Cash Receipts

	<u>Income</u>	<u>Principal</u>	<u>Total</u>
Nov. 1 Balance.....	215.00	10,115.00	10,330.00

The following entry should be made to record the transfer of the cash balances to the trustee:

Executor's Cash Disbursements

	<u>In-</u>	<u>Prin-</u>	<u>Total</u>
	come	cipal	Total
Nov. 1 W. C. Turner, Trustee..Transfer to trustee.	215	10,115	10,330

The closing of the executor's books is completed by the

following journal entries:

Nov. 1	Assets Not Inventoried.....	450.00	
	Gain on Realization.....	800.00	
	Estate Corpus.....		1,250.00
	To close accounts showing increases in corpus.		
	Estate Corpus.....	33,195.00	
	Loss on Realization.....		300.00
	Funeral and Administration Expense.....		535.00
	Debts of Decedent.....		3,360.00
	Legacy—Mary Henderson.....		28,000.00
	Legacy—W. C. Turner.....		1,000.00
	To close accounts showing decreases in corpus.		
	W. C. Turner, Trustee.....	40,000.00	
	<i>P Q</i> Co. Stock.....		10,000.00
	<i>S T</i> Co. Bonds.....		25,000.00
	<i>L M</i> Co. Bonds.....		5,000.00
	To record transfer of residuary legacy to trustee. (See cash book entry for transfer of \$10,115.00 cash.)		
	Estate Corpus.....	50,115.00	
	W. C. Turner, Trustee.....		50,115.00
	To close the two accounts, thus completing the closing entries as to corpus.		
	Income.....	610.00	
	Expense—Income.....		110.00
	Distributions of Income Cash.....		500.00
	To close the accounts showing payments out of income.		
	W. C. Turner—Trustee.....	950.00	
	Accrued Interest Receivable.....		450.00
	Dividends Receivable.....		500.00
	To record transfer of income assets to trustee. (See cash book entry for transfer of \$215.00 income cash.)		
	Income.....	1,165.00	
	W. C. Turner, Trustee.....		1,165.00
	To close the two accounts, thus completing the closing entries as to income.		

Opening the trustee's books.—The following cash book and journal entries will open the books of the trustee:

		<u>Trustee's Cash Receipts Book</u>		
		<u>Income</u>	<u>Principal</u>	<u>Total</u>
Nov. 1	Trust Principal.....		10,115.00	10,115.00
1	Income.....	215.00		215.00

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Trustee's Journal

Nov. 1	<i>P Q</i> Co. Stock.....	10,000.00	
	<i>S T</i> Co. Bonds.....	25,000 00	
	<i>L M</i> Co. Bonds.....	5,000.00	
	Trust Principal.....		40,000 00
	To take up assets as to principal.		
	Accrued Interest Receivable	450.00	
	Dividends Receivable..	500.00	
	Income.....		950.00
	To take up assets as to income.		

CHAPTER 57

BUDGETS

Nature of a budget.—A budget is an operating and financial program for a future period, based on results attained in prior periods and on data obtained by research and analysis. A budget is developed by:

- (1) Making forecasts of such items as:
 - (a) Sales.
 - (b) Production costs.
 - (c) Distribution expenses.
 - (d) Administrative expenses.
 - (e) Financial expenses.
 - (f) Additions to capital assets.
- (2) Assembling these forecasts of details into:
 - (a) An estimated profit and loss statement for the budget period.
 - (b) An estimated statement of cash requirements and sources of receipts to meet such requirements.
 - (c) An estimated balance sheet at the end of the budget period.

Length of the budget period.—The budget period should be long enough to allow for seasonal fluctuations in operations and in financial requirements, and for the length of the merchandise turnover period and the production period. If the budget covers too long a period, many unforeseeable conditions having a material effect on operations may arise. A more workable plan can be formulated for a three months' period than for a period of a year. However, there is considerable advantage in having at least a skeleton plan for a year in advance. It is sometimes found desirable to prepare a skeleton budget for a year and a detailed budget for three months. The skeleton budget is used primarily as a basis for general plans and policies, whereas the three months'

budget is used to control the current operations. When the latter method is used, the yearly plan is revised at the end of each quarter to include a year in advance. A yearly budget divided into twelve months, with monthly comparisons, is usually the most successful plan of operation for smaller organizations.

Chapter outline.—In connection with the explanation of budget procedure in this chapter, we shall prepare a budget of The A B Company. The company's balance sheet as of December 31, 1934, is presented below; the budget will cover the year 1935.

THE A B COMPANY		Exhibit A
Balance Sheet—December 31, 1934		
Assets		
Current Assets:		
Cash.....	\$ 350,000	
Receivables.....	\$1,840,000	
Less Reserve for Bad Debts.....	90,000	1,750,000
Inventories:		
Finished Goods.....	\$ 623,000	
Goods in Process.....	150,000	
Raw Materials.....	400,000	1,173,000
		\$3,273,000
Deferred Charges:		
Factory Supplies.....	\$ 15,000	
Unexpired Insurance.....	18,000	
Prepaid Interest.....	7,000	40,000
Fixed Assets:		
Land.....	\$ 500,000	
Buildings.....	\$2,150,000	
Equipment.....	3,500,000	
Total.....	\$5,650,000	
Less Reserve for Depreciation.....	1,350,000	4,300,000
		4,800,000
		<u>\$8,113,000</u>
Liabilities and Net Worth		
Current Liabilities:		
Notes Payable—Bank Loans.....	\$ 750,000	
Accounts Payable.....	180,000	
Accrued Taxes—Local.....	35,000	
Accrued Taxes—Federal Income.....	60,000	
Accrued Mortgage Interest.....	6,250	1,031,250
Mortgage Payable.....		500,000
Net Worth:		
Preferred Capital Stock.....	\$1,500,000	
Common Capital Stock.....	3,000,000	
Surplus.....	2,081,750	6,581,750
		<u>\$8,113,000</u>

To simplify the illustrations, we shall present only the budget for the year as a whole; it should be understood that, for practical use, the budget should be detailed by monthly or quarterly periods.

We shall first present the estimates of details, such as sales, production costs, expenses, and capital expenditures, and shall then note how the details are assembled into the principal budget statements.

Relation of expense and income to cash.—The budget should include a statement of estimated income and expense and a statement of estimated cash receipts and disbursements. These statements will naturally differ because of such matters as depreciation and bad debt reserve provisions, accruals and deferred items, and lags between sales and collections and between purchases and payments. Therefore the estimate of each operating detail should show the amounts to appear in the operating budget and those to appear in the cash budget.

Budgets of Sales and Collections from Customers

Estimated future sales.—In the preparation of a budget, the sales estimate is generally used as the basis, or point of departure, because all of the activities of an enterprise are usually limited by its sales possibilities. However, the sales estimates should not dictate the policies of the general budget program, except in so far as the general budget is limited by the sales possibilities. The sales department sometimes prepares the basic estimates, and all other departments are required to make their programs conform to the sales estimates. However, this procedure does not make for a coördinated program. The original sales estimates should be used as a starting basis only; if the carrying out of these estimates would result in an unbalanced program in the other departments, the sales estimates should be revised until the entire budget covering all departmental activities represents an efficient program of operation for all departments.

The sales estimates should be based on:

- (1) A study of past results. The sales department should be furnished with reports showing the sales of the last several years, analyzed by products, salesmen,

branches, geographical divisions, and so forth. These reports should be prepared on a quantity basis rather than on a dollar basis.

- (2) A product analysis, showing the extent of the demand for each product, the available gross profit, and the distribution cost; such an analysis may show that some products should be discontinued.
- (3) A market survey, based on customer demand and competition in various geographical territories, showing the sales opportunities, and indicating where the future sales can probably be obtained with least resistance.

The first sales estimates should be made by the salesmen. Each salesman should be given information, applicable to his territory, regarding past sales; sales opportunities, as indicated by the product analysis and the market survey; and the amount to be spent for advertising. He should also be told the prices which have been tentatively set.

The salesmen's estimates should then be given to the sales executives, who will decide whether to accept or to revise the quotas. No general ratio of increase over last year should be requested; each individual salesman's quota should be considered separately. Last year's sales should be considered as the base in each case, and the amount of any budgeted increase or decrease should be influenced by the ratio of past sales to sales opportunity. In some cases, it will be found conservative not to anticipate any increases in territory that is well covered; and if customers have been overloaded, it may be necessary to consider the possibility of decreases. No salesman should be permitted to undertake a task that is unreasonable, and he should be able to show definitely how he expects to secure his increase. On the other hand, the sales executives should not be satisfied with quotas which are not progressive.

After the final estimates of sales in quantities have been set by the sales executives, it will be necessary to apply the sales prices to the quantities so that the sales may be expressed in terms of both units and dollars.

As a simple illustration, let us assume that The A B Company manufactures a single article which it proposes

to sell during 1935 at \$50.00 each. The following statement shows the estimates that represent the company's sales budget for the year:

THE A B COMPANY Schedule 1
Sales Budget
Year Ending December 31, 1935

Salesman	Units Sold, 1934	1935 ESTIMATES		
		Units	Price	Amount
A.....	13,500	14,500	\$50.00	\$ 725,000.00
B.....	18,500	18,000	50.00	900,000.00
C.....	20,000	21,500	50.00	1,075,000.00
D.....	19,500	21,000	50.00	1,050,000.00
E.....	15,000	16,400	50.00	820,000.00
F.....	17,500	18,200	50.00	910,000.00
G.....	15,000	16,000	50.00	800,000.00
Total	<u>119,000</u>	<u>125,600</u>	<u>50.00</u>	<u>\$6,280,000.00</u>

Collections from customers.—The method of estimating cash receipts from collections will depend upon the type of business. If all the sales of the business were cash sales, the total of the estimated sales as shown by the sales budget would represent the cash collections. However, this is very seldom the case, and an analysis will show that the collections will usually involve some proportionate lag on sales. This lag may be determined by scheduling the sales by weekly or monthly periods for several prior years and scheduling the collections for the same periods. A graphical presentation of these facts will show the gap between sales and collections.

Another method of determining the relationship between sales and collections is to determine the number of days' billings included in accounts receivable, based upon past experience, as follows:

Computation for The A B Company

Sales, 1934.....	\$5,950,000.00
Accounts Receivable, December 31, 1934.....	1,840,000.00
Per Cent of Sales Uncollected $\$1,840,000.00 \div \$5,950,000.00 =$	30.92%
Multiplied by.....	365
Days' Sales Uncollected.....	<u>113</u>

The cash receipts from collections for The A B Company will be estimated as follows:

THE A B COMPANY Schedule 2
Statement of Estimated Collections from Customers
Year Ending December 31, 1935

Receivables, December 31, 1934 (Exhibit A).....	\$1,840,000 00
Sales for 1935 (Schedule 1)	6,280,000 00
Total	\$8,120,000.00
Deduct:	
Bad Debts to be Charged to Reserve..... \$ 50,000.00	
Estimated Receivables, December 31, 1935:	
^{11 3/8} / ₆₅ of \$6,280,000.....	1,944,000 00
	1,994,000 00
Accounts Collected.....	\$6,126,000.00
Probable Discounts Taken, Based on Experience of .75% of	
Accounts Collected.....	46,000 00
Cash Collections.....	\$6,080,000.00

The Production Budget

Quantity to be produced.—The number of units of finished goods to be produced during the budget period should be determined on the basis of the estimated sales, the desired closing inventory, and the available inventory at the beginning of the period. Assuming that the inventory of The A B Company, at the beginning of 1935, contains 18,500 units, and that it is desired to have 20,500 units on hand at the end of the year, the quantity to be manufactured may be determined as follows:

THE A B COMPANY Schedule 3
Estimate of Quantity of Finished Goods to be Manufactured
Year Ending December 31, 1935

Required to Meet Sales Deliveries (per Schedule 1, page 497)....	125,600
Desired for Inventory, December 31, 1935.....	20,500
Total.....	146,100
Available in Inventory, January 1, 1935.....	18,500
Quantity to be Manufactured.....	127,600

So far as possible, the production program should contemplate an even flow of production during the budget period, in order to avoid wastes due to the changing and training of labor, overtime rates, dissatisfied employees, and so forth.

Material purchases budget.—After the quantity to be manufactured has been determined, it is necessary to estimate the material purchases which must be made in order to meet the production requirements. A specification sheet will be prepared, showing the different kinds and the amounts of

materials required to meet the manufacturing schedule.

The quantities to be purchased will be determined on the basis of these specification sheets, with due consideration of the inventories at the beginning of the period and the desired inventories at the end of the period. One of the major values of a budget lies in the proper coördination of the purchase program and the manufacturing program for the purpose of avoiding excessive and unbalanced inventories.

The purchase requirements based upon material specifications, spoilage allowances (if any), and material inventory requirements, may be modified by the amount of material already in goods in process. However, if the goods in process at the beginning of the period represent a normal inventory and if it is expected that a like amount of goods will remain in process at the end of the period, the allowance for goods in process may be ignored.

Assuming that only one item of raw materials is used by The *A B* Company, that there are 20,000 units of this material in the opening inventory, and that it is desired to have 22,500 units in the closing inventory, the material purchase requirements for the year may be budgeted as follows:

THE A B COMPANY	<u>Schedule 4</u>
Estimate of Quantity and Cost of Raw Materials to be Purchased	
Year Ending December 31, 1935	
Required for Finished Goods to be Manufactured (per Schedule 3, page 498).....	127,600
Desired for Inventory, December 31, 1935.....	22,500
Total.....	<u>150,100</u>
Available in Inventory, January 1, 1935.....	20,000
Quantity to be Purchased.....	<u>130,100</u>
Estimated Unit Cost.....	\$ 20
Estimated Total Cost.....	<u>\$2,602,000</u>

The purchases should be apportioned to the various months, with consideration of the following factors:

- (1) Minimum inventory requirement to meet manufacturing program.
- (2) Maximum inventory allowable.
- (3) Purchasing economies.
- (4) Quantity which constitutes an economical buy.
- (5) Distance from source of supply.
- (6) Available storeroom space.

Estimated payments to material suppliers.—The payments to material suppliers are estimated as follows:

THE A B COMPANY		<u>Schedule 5</u>
Estimate of Payments on Accounts Payable		
Year Ending December 31, 1935		
Accounts Payable, December 31, 1934 (Exhibit A).....		\$ 180,000
Purchases (Schedule 4).....		2,602,000
Total.....		<u>\$2,782,000</u>
Deduct Estimated Accounts Payable, December 31, 1935, Representing Estimated December Invoices.....		200,000
Accounts to be Paid.....		<u>\$2,582,000</u>
Probable Discounts to be Taken, Based on Experience of 1.6% of Accounts Paid.....		41,300
Cash Payments.....		<u>\$2,540,700</u>

The labor budget.—The direct labor cost for the manufacture of 127,600 units (see Schedule 3, page 498) is estimated in the following schedule, on the basis of the estimated labor cost in each of the manufacturing departments.

THE A B COMPANY		<u>Schedule 6</u>	
Estimated Direct Labor Cost			
Year Ending December 31, 1935			
<u>Department</u>	<u>Quantity to be Produced</u>	<u>Standard Labor Cost Per Unit</u>	<u>Total Estimated Labor Cost</u>
1.....	127,600	\$.90	\$115,000.00
2.....	127,600	1.60	204,000.00
3.....	127,600	1.12	143,000.00
4.....	127,600	1.75	223,000.00
5.....	127,600	1.30	166,000.00
	127,600	<u>\$6.67</u>	<u>\$851,000.00</u>

It is assumed that the direct labor costs will be paid in full during the year; the cash disbursements will therefore be equal to the operating charge.

The manufacturing expense budget.—Certain elements of manufacturing expense are fixed charges which will not vary with production; the amounts of other expenses will vary with the quantity of production. In preparing the manufacturing expense budget, it is necessary to have available information concerning the actual manufacturing expenses during prior periods, the relation of these expenses to quantities produced, and the production schedule contemplated by the budget.

Some of the manufacturing expenses will be paid when incurred. Others will not: Depreciation will be provided by credits to reserves; indirect materials will be charged to stores when purchased, and to expense when used; insurance will be charged to a prepaid expense account and written off on the basis of expirations; taxes will be set up in an accrued account, to which payments will subsequently be charged.

The manufacturing expenses and the cash payments therefor are estimated as follows:

		THE A B COMPANY				Schedule 7	
		Estimated Manufacturing Expenses					
		Year Ending December 31, 1935					
		1935 ESTIMATES					
		Increase (Decrease*)					
	1934		Inven-	Deferred	Accrued	Re-	
	Actual	Expense	to-	Charges	Expense	serve	Cash
			ries			s	
Indirect Labor.....	\$180,000	\$185,000					\$185,000
Indirect Material	93,000	112,600	\$3,500				116,100
Light, Heat, and Power..	67,000	75,000					75,000
Repairs to Equipment..	65,000	68,000					68,000
Depreciation	330,000	350,000				\$350,000	
Taxes	32,000	36,000			\$1,000		35,000
Insurance	25,000	27,000		\$2,000			29,000
Factory Office Expense	18,000	18,000					18,000
Total	<u>\$810,000</u>	<u>\$871,600</u>	<u>\$3,500</u>	<u>\$2,000</u>	<u>\$1,000</u>	<u>\$350,000</u>	<u>\$526,100</u>

Budget of Cost of Goods to be Sold

Estimates already made.—Thus far the following items to be used in the statement of the estimated cost of goods to be sold during 1935, appearing on page 502, have been determined:

Manufacturing costs:		
Material purchases (Schedule 4, page 499).....		\$2,602,000.00
Direct labor (Schedule 6, page 500).....		851,000.00
Manufacturing expense (Schedule 7, above).....		871,600.00
Raw materials inventories:		
January 1—20,000 units at \$20.00 each (Exh. A, page 494).		400,000.00
December 31—22,500 units at \$20.00 each (Schedule 4)....		450,000.00
Goods in process inventories:		
January 1 (Exhibit A).....		150,000.00
December 31 (assuming no change).....		150,000.00
Finished goods inventories:		
January 1—18,500 units (Exhibit A).....		623,000.00
December 31—20,500 units (Schedule 3, page 498).....		?

The value of the December 31 inventory of finished goods is estimated on the basis of manufacturing costs for 1935, as determined by the estimates presented on the foregoing pages and summarized as follows:

**Estimate of Inventory Value
December 31, 1935**

Materials:	
Inventory, January 1.....	\$ 400,000.00
Purchases.....	2,602,000.00
Total.....	<u>\$3,002,000.00</u>
Less inventory, December 31.....	450,000.00
Materials used.....	<u>\$2,552,000.00</u>
Direct labor.....	851,000.00
Manufacturing expense....	871,600.00
Total.....	<u>\$4,274,600.00</u>
Units to be manufactured.....	127,600
Unit cost.....	\$ 33.50
Units in December 31 inventory.....	20,500
Inventory value.....	<u>\$ 686,750.00</u>

Forecast of cost of sales.—On the basis of this data, the cost of goods to be sold during 1935 may be estimated as follows:

THE A B COMPANY

Schedule 8

**Statement of Estimated Cost of Sales
Year Ending December 31, 1935**

Raw Materials:	
Inventory, January 1.....	\$ 400,000.00
Purchases.....	2,602,000.00
Total.....	<u>\$3,002,000.00</u>
Less Inventory, December 31.....	450,000.00
Materials Cost.....	<u>\$2,552,000.00</u>
Direct Labor.....	851,000.00
Manufacturing Expense.....	871,600.00
Total.....	<u>\$4,274,600.00</u>
Variation of Goods in Process Inventory:	
January 1.....	\$ 150,000.00
December 31.....	<u>150,000.00</u>
Variation.....	—
Cost of Goods Manufactured.....	<u>\$4,274,600.00</u>
Variation of Finished Goods Inventory:	
January 1.....	\$ 623,000.00
December 31.....	<u>686,750.00</u>
Increase.....	63,750.00
Cost of Sales.....	<u>\$4,210,850.00</u>

Selling and Administrative Expense Budgets

Fixed and variable expenses.—The expenses should be estimated on the basis of the amounts for prior years, modified by any changes which are likely to result from the change in sales. Therefore, in making the estimates, it is desirable to divide the expenses into two groups: Fixed, or expenses that are not likely to be affected greatly by changes in sales; and variable, or expenses likely to increase or decrease with the sales.

Some of the methods of increasing the sales are:

- (1) Increasing sales price, unit sales remaining the same.
- (2) Increasing unit sales by:
 - (a) Selling more goods to present customers.
 - (b) Seeking new customers.
- (3) Spending more for advertising and sales promotion.
- (4) Hiring additional salesmen.
- (5) Requiring additional volume from present salesmen.
- (6) Seeking larger volume per order.

The methods to be employed in increasing sales volume have a direct bearing on the classification of expenses as fixed and variable, and this fact should therefore be kept in mind when the expense budgets are made up. If it is proposed to increase the sales by increasing sales prices—unit sales remaining the same,—there should be little variation in salesmen's salaries and traveling expenses, freight out, office expenses, bad debts, and so forth; but advertising and promotion expense may increase, in order to overcome sales resistance. If it is proposed to increase sales by increasing the number of units sold, particularly if this is to be accomplished by adding to the sales force and seeking new customers, most of the selling expenses and some of the administrative expenses will necessarily increase.

Selling expense budget.—Following is the estimate of selling expenses of The *A B* Company for 1935. All of these expenses will be paid in the month in which they are incurred, except advertising, which will be paid in the subsequent month; the unpaid advertising bill at the end of 1935 is estimated at \$30,000.00.

THE A B COMPANY
Statement of Estimated Selling Expenses
Year Ending December 31, 1935

Schedule 9

	1934 Actual	1935 ESTIMATE		
		Expense	Accounts Payable	Cash
Sales Management Salaries	\$ 33,000	\$ 35,000		\$ 35,000
Rent of Sales Offices	28,000	28,000		28,000
Sales Clerical Expense	18,000	18,000		18,000
Salesmen's Salaries	350,000	375,000		375,000
Delivery Expenses	93,000	95,000		95,000
Sales Commissions and Bonuses	60,000	65,000		65,000
Advertising	215,000	252,000	\$30,000	222,000
Traveling Expenses	90,000	85,000		85,000
Total	\$887,000	\$953,000	\$30,000	\$923,000

In addition to this general budget, a separate budget should be prepared, showing the amount of expenditures allowed each of the sales territories, and the amount allowed the general sales office. The sum of these territorial and general allotments will agree with the aggregate budgeted in Schedule 9. All of these budgets should be apportioned by months, so that frequent comparisons can be made of the budgeted and the actual expenses.

Administrative expenses.—The theory of budgetary control can be applied very effectively to the administrative expenses of a business. Control of the administrative expenses within certain bounds very often is the deciding factor in producing a profit. Following is the administrative expense budget of The A B Company:

THE A B COMPANY
Statement of Estimated Administrative Expenses
Year Ending December 31, 1935

Schedule 10

	1934 Actual	1935 ESTIMATE		
		Expense	Reserves	Cash
Management Salaries \$ 90,000.00	\$ 95,000.00			\$ 95,000.00
Depreciation	31,000.00	35,000.00	\$35,000.00	
Rent	25,000.00	25,000.00		25,000.00
Corporate Expenses	30,000.00	35,000.00		35,000.00
Office Salaries	82,000.00	85,000.00		85,000.00
Office Supplies	14,000.00	14,000.00		14,000.00
Communication	12,000.00	12,000.00		12,000.00
Traveling	7,500.00	9,000.00		9,000.00
Bad Debts	52,000.00	60,000.00	60,000.00	
Total	\$343,500.00	\$370,000.00	\$95,000.00	\$275,000.00

Additions to Capital Assets

Relation to cash and operating budgets.—The contemplated additions to capital assets must necessarily be determined before the budget of cash receipts and disbursements can be prepared, because the additions to capital assets will involve expenditures which will have to be reflected in the statement of estimated cash disbursements. Moreover, if any additional securities are to be issued to finance the capital expenditures, the interest charges on these securities must be reflected in the operating budget and the cash budget.

The estimates of capital additions should be made by the plant superintendent and the purchasing department, after a consideration of the production budget and the plans for subsequent expansion.

Following is the summary of the budget of plant additions of The *A B* Company:

THE <i>A B</i> COMPANY		<u>Schedule 11</u>
Statement of Estimated Additions to Capital Assets		
Year Ending December 31, 1935		
Land.....	\$ 100,000.00	
Buildings.....	750,000.00	
Equipment.....	450,000.00	
Total—To Be Paid in Cash.	<u>\$1,300,000.00</u>	

Financial Budget

Bank loans and securities.—The proposed changes in bank loans, mortgages, and stock issues are shown below:

THE <i>A B</i> COMPANY		<u>Schedule 12</u>		
Estimated Changes in Loans, Mortgages, and Stock				
Year Ending December 31, 1935				
	Balances, December 31, 1934	<u>CHANGES</u>		Balances, December 31, 1935
		Increases	Decreases	
Bank Loans:				
Present.....	\$ 750,000		\$750,000	
New.....		\$ 900,000		\$ 900,000
Mortgage:				
On Old Plant—5%.....	500,000			500,000
On New Plant—6%.....		250,000		250,000
Capital Stock:				
Preferred.....	1,500,000	500,000		2,000,000
Common.....	3,000,000			3,000,000
	<u>\$5,750,000</u>	<u>\$1,650,000</u>	<u>\$750,000</u>	<u>\$6,650,000</u>

Interest.—The interest expense for 1935 is estimated as follows:

Notes Payable, January 1, 1935	\$ 750,000.00	
Notes Payable, December 31, 1935	900,000.00	
Total	<u>\$1,650,000.00</u>	
Average Notes Payable.	\$ 825,000.00	
Interest at 6½%		\$53,625.00
Mortgage Payable—Old.	500,000.00	
Interest at 5%		25,000.00
Mortgage Payable to be Dated March 31, 1935. . .	250,000.00	
Interest at 6%		<u>11,250.00</u>
Total		<u>\$89,875.00</u>

The interest expense charges and the cash payments therefor will differ because of the prepaid interest on bank loans and the accrued interest on mortgages at the beginning and the end of the year.

THE A B COMPANY Schedule 13
Estimated Interest Expenses
Year Ending December 31, 1935

	Ex- pense	PREPAID		ACCRUED		Cash
		Janu- ary 1	Decem- ber 31	Janu- ary 1	Decem- ber 31	
Interest on Bank Loans ..	\$53,625	\$7,000	\$9,000			\$55,625
Interest on Mortgages:						
Old	25,000			\$6,250	\$ 6,250	25,000
New	11,250				3,750	7,500
Total	<u>\$89,875</u>	<u>\$7,000</u>	<u>\$9,000</u>	<u>\$6,250</u>	<u>\$10,000</u>	<u>\$88,125</u>

Dividends.—The proposed dividends for the year on preferred and common stocks are shown below:

THE A B COMPANY Schedule 14
Statement of Estimated Dividend Payments
Year Ending December 31, 1935

	Par of Stock	Rate	Amount
Preferred	\$2,000,000.00	7%	\$140,000.00
Common	3,000,000.00	8	240,000.00
Total			<u>\$380,000 00</u>

Federal income tax.—Federal income tax accruals and payments are estimated in the schedule on the following page.

THE A B COMPANY

Schedule 15

Estimated Income Tax Payments and Accruals

Year Ending December 31, 1935

Tax Accrued for 1934—To be Paid.....	<u>\$60,000.00</u>
Estimated Tax Accrual for 1935.....	<u>\$78,000.00</u>

Assembling the Budgets

Working papers.—The opening balance sheet is entered in the working papers (see pages 509 to 514), and the budget estimates are journalized and posted thereto.

Schedule

1	Receivables.....	6,280,000.00	
	Sales.....		6,280,000.00
	Estimated sales.....		
2	Cash.....	6,080,000.00	
	Discount on Sales.....	46,000.00	
	Reserve for Bad Debts.....	50,000.00	
	Receivables.....		6,176,000.00
	Collections, discounts, and write-offs.....		
4	Purchases—Raw Materials.....	2,602,000.00	
	Accounts Payable.....		2,602,000.00
	Material purchases.....		
5	Accounts Payable.....	2,582,000.00	
	Discount on Purchases.....		41,300.00
	Cash.....		2,540,700.00
	Payments to material suppliers.....		
6	Direct Labor.....	851,000.00	
	Cash.....		851,000.00
	Payments for direct labor.....		
7	Manufacturing Expense:		
	Indirect Labor.....	185,000.00	
	Indirect Material.....	112,600.00	
	Light, Heat, and Power.....	75,000.00	
	Repairs to Equipment.....	68,000.00	
	Depreciation.....	350,000.00	
	Taxes.....	36,000.00	
	Insurance.....	27,000.00	
	Factory Office Expense.....	18,000.00	
	Factory Supplies (Inventory increase).....	3,500.00	
	Prepaid Insurance (Increase).....	2,000.00	
	Accrued Taxes (Increase).....		1,000.00
	Reserve for Depreciation.....		350,000.00
	Cash.....		526,100.00
8	Finished Goods.....	686,750.00	
	Goods in Process.....	150,000.00	
	Raw Materials.....	450,000.00	
	Profit and Loss.....		1,286,750.00
	Inventories at end of year.....		

Schedule

9	Sales Management Salaries.....	35,000.00	
	Rent of Sales Office.	28,000.00	
	Sales Clerical Expense	18,000.00	
	Salesmen's Salaries.....	375,000.00	
	Delivery Expenses.	95,000.00	
	Sales Commissions and Bonuses	65,000.00	
	Advertising.	252,000.00	
	Traveling Expenses.	85,000.00	
	Accounts Payable		30,000.00
	Cash.....		923,000.00
10	Management Salaries.....	95,000.00	
	Depreciation.	35,000.00	
	Rent.	25,000.00	
	Corporate Expenses.	35,000.00	
	Office Salaries.	85,000.00	
	Office Supplies.....	14,000.00	
	Communication.....	12,000.00	
	Traveling Expenses.. . . .	9,000.00	
	Bad Debts.....	60,000.00	
	Reserve for Depreciation.....		35,000.00
	Reserve for Bad Debts.....		60,000.00
	Cash.....		275,000.00
11	Land.....	100,000.00	
	Buildings.....	750,000.00	
	Equipment.....	450,000.00	
	Cash.....		1,300,000.00
12	Bank Loans.....	750,000.00	
	Cash.		750,000.00
	Payment of present loans.		
	Cash.....	1,650,000.00	
	Bank Loans.....		900,000.00
	Mortgage Payable—New		250,000.00
	Preferred Capital Stock.....		500,000.00
	Loans, and securities issued.		
13	Interest on Bank Loans.....	53,625.00	
	Interest on Mortgages.....	36,250.00	
	Prepaid Interest (Increase).....	2,000.00	
	Accrued Interest (Increase).....		3,750.00
	Cash.....		88,125.00
	Interest expense and payments.		
14	Dividends on Preferred Stock.....	140,000.00	
	Dividends on Common Stock.....	240,000.00	
	Cash.....		380,000.00
15	Accrued Taxes—Federal Income.....	60,000.00	
	Cash.....		60,000.00
	Payment of 1934 tax.		
	Federal Income Tax.....	78,000.00	
	Accrued Taxes—Federal Income..		78,000.00
	Estimated accrual for 1935.		

THE A B COMPANY

Working Papers

Estimated Statement of Cost of Goods Manufactured and Sold
Year Ending December 31, 1935

Sheet 1

	BALANCES, DECEMBER 31, 1934		JOURNAL ENTRIES		STATEMENT
	Debit	Credit	Debit	Credit	
Raw Materials:					
Inventory—December 31, 1934.....	400,000				400,000
Purchases.....			2,602,000(4)		2,602,000
Total.....				450,000(8)	3,002,000
Inventory—December 31, 1935.....					450,000
Materials Used.....			851,000(6)		2,552,000
Direct Labor.....					851,000
Manufacturing Expenses:					
Indirect Labor.....			185,000(7)		185,000
Indirect Material.....			112,600(7)		112,600
Light, Heat, and Power.....			75,000(7)		75,000
Repairs to Equipment.....			68,000(7)		68,000
Depreciation.....			350,000(7)		350,000
Taxes.....			36,000(7)		36,000
Insurance.....			27,000(7)		27,000
Factory Office Expense.....			18,000(7)		18,000
Total Manufacturing Expense.....					871,600
Total Material, Labor, and Expense.....					4,274,600
Inventory Variation—Goods in Process:					
Inventory—December 31, 1934.....	150,000				150,000
Inventory—December 31, 1935.....				150,000(8)	150,000
Cost of Goods Manufactured.....					—
Inventory Variation—Finished Goods:					
Inventory—December 31, 1934.....	623,000				623,000
Inventory—December 31, 1935.....				686,750(8)	686,750
Increase.....					63,750
Cost of Goods Sold (Forward to Sheet 2).....					4,210,850
Totals (Forward to Sheet 2).....	1,173,000	—	4,324,600	1,286,750	4,210,850

THE A B COMPANY
Working Papers

Estimated Profit and Loss Statement
Year Ending December 31, 1935

Sheet 2

	BALANCES, DECEMBER 31, 1934		JOURNAL ENTRIES		STATEMENT
	Debit	Credit	Debit	Credit	
Totals (Brought forward from Sheet 1).....	1,173,000.00	—	4,324,800.00	1,286,750.00	6,280,000.00
Sales.....				6,280,000.00(1)	4,210,850.00
Cost of Goods Sold (Brought forward from Sheet 1).....					2,069,150.00
Gross Profit on Sales.....					
Selling Expenses:					
Sales Management Salaries.....			35,000.00(9)		35,000.00
Rent of Sales Office.....			28,000.00(9)		28,000.00
Sales Clerical Expense.....			18,000.00(9)		18,000.00
Salesmen's Salaries.....			375,000.00(9)		375,000.00
Delivery Expenses.....			95,000.00(9)		95,000.00
Sales Commissions and Bonuses.....			65,000.00(9)		65,000.00
Advertising.....			252,000.00(9)		252,000.00
Traveling Expenses.....			85,000.00(9)		85,000.00
Total Selling Expenses.....					953,000.00
Net Profit on Sales.....					1,116,150.00
Administrative Expenses:					
Management Salaries.....			95,000.00(10)		95,000.00
Depreciation.....			35,000.00(10)		35,000.00
Rent.....			25,000.00(10)		25,000.00
Corporate Expenses.....			35,000.00(10)		35,000.00
Office Salaries.....			85,000.00(10)		85,000.00
Office Supplies.....			14,000.00(10)		14,000.00
Communication.....			12,000.00(10)		12,000.00
Traveling Expenses.....			9,000.00(10)		9,000.00
Bad Debts.....			60,000.00(10)		60,000.00
Total Administrative Expenses.....					370,000.00
Net Profit on Operations.....					746,150.00
Net Financial Expenses:					
Interest on Mortgages.....			36,250.00(13)		36,250.00
Interest on Bank Loans.....			53,625.00(13)		53,625.00
Discount on Sales.....			46,000.00(2)		46,000.00
Total.....				41,300.00(5)	135,875.00
Less Discount on Purchases.....					41,300.00
Net Financial Expense.....					94,575.00
Net Income Before Federal Income Tax.....					651,575.00
Federal Income Tax.....			78,000.00(15)		78,000.00
Net Income (Forward to Sheet 3).....					573,575.00
Totals (Forward to Sheet 3).....	1,173,000.00	—	5,861,475.00	7,608,050.00	573,575.00

THE A B COMPANY

Working Papers

**Estimated Surplus Statement
Year Ending December 31, 1935**

Sheet 3

	BALANCES, DECEMBER 31, 1934		JOURNAL ENTRIES		STATEMENT
	Debit	Credit	Debit	Credit	
Totals (Brought forward from Sheet 2).....	1,173,000	2,081,750	5,861,475	7,608,050	2,081,750
Surplus—December 31, 1934.....					<u>573,575</u>
Net Income for the Year (Brought forward from Sheet 2)					2,655,325
Total.....					<u>2,275,325</u>
Less Dividends:					
On Preferred Stock—7%.....			140,000(14)		140,000
On Common Stock—8%.....			240,000(14)		<u>380,000</u>
Balance—December 31, 1934 (Forward to Sheet 6).....					240,000
Totals (Forward to Sheet 6).....	<u>1,173,000</u>	<u>2,081,750</u>	<u>6,241,475</u>	<u>7,608,050</u>	<u>2,275,325</u>

THE A B COMPANY

Working Papers

Estimated Statement of Cash Receipts and Disbursements
Year Ending December 31, 1935

Sheet 4

	BALANCES, DECEMBER 31, 1934		JOURNAL ENTRIES		STATEMENT
	Debit	Credit	Debit	Credit	
Balance, December 31, 1934.....	350,000				350,000
Receipts:					
Accounts Receivable.....			6,080,000(2)		6,080,000
Bank Loans.....			900,000(12)		900,000
Mortgage on New Plant.....			250,000(12)		250,000
Preferred Stock.....			500,000(12)		500,000
Total Receipts.....					7,730,000
Total.....					8,080,000
Disbursements:					
Material Suppliers.....			2,540,700(5)		2,540,700
Direct Labor.....			851,000(6)		851,000
Manufacturing Expenses.....			526,100(7)		526,100
Selling Expenses.....			923,000(9)		923,000
Administrative Expenses.....			275,000(10)		275,000
Interest.....			88,125(13)		88,125
Federal Income Tax—1934.....			60,000(15)		60,000
Bank Loans—December 31, 1934.....			750,000(12)		750,000
Dividends:					
Preferred Stock.....			140,000(14)		140,000
Common Stock.....			240,000(14)		240,000
Additions to Capital Assets:					
Land.....			100,000(11)		100,000
Buildings.....			750,000(11)		750,000
Equipment.....			450,000(11)		450,000
Total Disbursements.....					7,693,925
Balance, December 31, 1935 (Forward to Sheet 5).....					386,075
Totals (Forward to Sheet 5).....	350,000	—	7,730,000	7,693,925	

THE A B COMPANY

Working Papers

Estimated Balance Sheet—Assets

December 31, 1935

Sheet 5

	BALANCES,		JOURNAL ENTRIES		STATEMENT
	DECEMBER 31, 1934		Debit	Credit	
Current Assets:					
Cash (Brought forward from Sheet 4).....	350,000		7,730,000	7,693,925	386,075
Receivables.....	1,840,000		6,280,000(1)	6,176,000(2)	1,944,000
Less Reserve for Bad Debts.....		90,000	50,000(2)	60,000(10)	100,000
Inventories:					1,844,000
Finished Goods.....			686,750(8)		686,750
Goods in Process.....			150,000(8)		150,000
Raw Materials.....			450,000(8)		450,000
Total Current Assets.....					3,516,825
Deferred Charges:					
Factory Supplies.....	15,000		3,500(7)		18,500
Unexpired Insurance.....	18,000		2,000(7)		20,000
Prepaid Interest.....	7,000		2,000(13)		9,000
Total Deferred Charges.....					47,500
Fixed Assets:					
Land.....	500,000		100,000(11)		600,000
Buildings.....	2,150,000		750,000(11)		2,900,000
Equipment.....	3,500,000		450,000(11)		3,950,000
Total.....					7,450,000
Less Reserve for Depreciation.....		1,350,000		{ 350,000(7) }	1,735,000
Total Fixed Assets.....				{ 35,000(10) }	5,715,000
Total Assets.....	8,380,000	1,440,000	16,654,250	14,314,925	9,279,325
Totals (Forward to Sheet 6).....					

THE A B COMPANY

Working Papers

Estimated Balance Sheet—Liabilities and Net Worth

December 31, 1935

Sheet 6

	BALANCES,		JOURNAL ENTRIES		STATEMENT
	DECEMBER 31, 1934		Debit	Credit	
Totals (Brought forward from Sheet 5).....	8,380,000	1,440,000	16,654,250	14,314,925	
Current Liabilities:					
Notes Payable—Bank Loans.....		750,000	750,000(12)	900,000(12)	900,000
Accounts Payable.....		180,000	2,582,000(5)	2,602,000(4) }	230,000
Accrued Taxes—Local.....		35,000		1,000(7)	36,000
Accrued Taxes—Federal Income.....		60,000	60,000(15)	78,000(15)	78,000
Accrued Mortgage Interest.....		6,250		3,750(13)	10,000
Total Current Liabilities.....					<u>1,254,000</u>
Fixed Liabilities:					
Mortgage Payable—Old.....		500,000		250,000(12)	500,000
Mortgage Payable—New.....					<u>250,000</u>
Total Fixed Liabilities.....					750,000
Net Worth:					
Capital Stock:					
Preferred.....		1,500,000		500,000(12)	2,000,000
Common.....		3,000,000			<u>3,000,000</u>
Total.....		2,081,750			5,000,000
Surplus (Brought forward from Sheet 3).....					<u>2,275,325</u>
Total Net Worth.....					7,275,325
Total Liabilities and Net Worth.....	1,173,000		6,241,475	7,608,050	
(Other totals forward from Sheet 3).....	<u>9,553,000</u>	<u>9,553,000</u>	<u>26,287,725</u>	<u>26,287,725</u>	<u>9,279,325</u>

Analysis of the Budgets

Comparisons and ratios.—Before the estimates are finally approved, they should be analyzed by preparing comparative statements and by computing ratios, so that the management may determine whether the contemplated results are satisfactory.

Comparative balance sheet.—The comparative balance sheet with accompanying ratios, presented below, might cause the management to reconsider the entire budget. The student should note the per cents of change in the balance sheet ratios in comparison with the per cent of change in sales, and the decreases in all of the very significant ratios at the foot of the statement.

THE A B COMPANY				
Condensed Comparative Balance Sheet				
December 31, 1934 (Actual) and 1935 (Estimated)				
	DECEMBER 31		INCREASE (DECREASE*)	
	1935	1934	Amount	Per Cent
Assets				
Current Assets:				
Cash.....	\$ 386,075	\$ 350,000	\$ 36,075	10.31%
Receivables—Net.....	1,844,000	1,750,000	94,000	5.37
Inventories.....	1,286,750	1,173,000	113,750	9.70
Total.....	\$3,516,825	\$3,273,000	\$ 243,825	7.45
Deferred Charges.....	47,500	40,000	7,500	18.75
Fixed Assets—Net.....	5,715,000	4,800,000	915,000	19.06
	\$9,279,325	\$8,113,000	\$1,166,325	14.38
Liabilities and Net Worth				
Current Liabilities.....	\$1,254,000	\$1,031,250	\$ 222,750	21.60
Fixed Liabilities.....	750,000	500,000	250,000	50.00
Total Liabilities.....	\$2,004,000	\$1,531,250	\$ 472,750	30.87
Net Worth:				
Preferred Stock.....	\$2,000,000	\$1,500,000	\$ 500,000	33.33
Common Stock.....	3,000,000	3,000,000	—	—
Surplus.....	2,275,325	2,081,750	193,575	9.30
Total Net Worth.....	\$7,275,325	\$6,581,750	\$ 693,575	10.54
	\$9,279,325	\$8,113,000	\$1,166,325	14.38
Sales.....	\$6,280,000	\$5,950,000	\$ 330,000	5.55%
Working Capital Ratio.....	2.80	3.17	.37*	
Acid Test Ratio.....	1.78	2.04	.26*	
Ratio of Sales to Fixed Assets..	1.10	1.24	.14*	
Ratio of Net Worth to Fixed Assets.....	.1.27	1.37	.10*	
Ratio of Net Worth to Liabilities	3.63	4.30	.67*	

Comparative profit and loss statement.—The brief statement on page 517 compares the operation for 1934 with the proposed operations for 1935. Although the statement shows an increase in net income, the management might question the slightly increased ratios of selling and administrative expenses, and particularly the large increase in net financial expense; this latter increase arises largely from increases in fixed expenses, which affect the break-even point and may therefore be dangerous.

Similar comparative statements might be prepared to show the details of manufacturing costs and expenses.

Comparison of actual results with budget estimates.—Periodic comparisons of actual results with the budget estimates should be prepared. These comparisons should be made frequently, so that variations may be determined quickly and any improper variations investigated and corrected if possible.

If actual results indicate that it will be possible to operate within the budget estimates for the period, no revisions will be necessary. However, if results from time to time indicate that the budget estimates are considerably out of line, it will be necessary to revise the budget in order to take into consideration the new problems which have arisen as a result of current operating conditions. The budget should not be revised merely because some department is not meeting the budget requirements, but should be revised only when current conditions necessitate changes in the program of operations.

The periodic comparison of actual results with the budget is one of the most important parts of the budget program and is the chief means of enforcing the budget.

Classification of accounts.—To make the comparison of the actual results with the budget estimates of greatest value, it is necessary that the classification of accounts used in the budget conform to the classification of accounts used in reporting the actual results.

If the proper control of the business is to be exercised through the accounts, the classification of accounts should be so designed that for every person in the business who has power to requisition materials, labor, or funds, there will be a separate account or group of accounts showing what his

THE A B COMPANY
Condensed Comparative Profit and Loss Statement
1934 Actual and 1935 Estimated

	1935 ESTIMATED		1934 ACTUAL		INCREASE	
	Amount	Per Cent of Sales	Amount	Per Cent of Sales	Amount	Per Cent
Sales.....	\$6,280,000.00	100.00%	\$5,950,000.00	100.00%	\$330,000.00	5.55%
Cost of Goods Sold.....	4,210,850.00	67.05	4,100,000.00	68.91	110,850.00	2.70
Gross Profit on Sales.....	\$2,069,150.00	32.95%	\$1,850,000.00	31.09%	\$219,150.00	11.85
Selling Expenses.....	953,000.00	15.18	887,000.00	14.91	66,000.00	7.44
Net Profit on Sales.....	\$1,116,150.00	17.77%	\$963,000.00	16.18%	\$153,150.00	15.90
Administrative Expenses.....	370,000.00	5.89	343,500.00	5.77	26,500.00	7.71
Net Profit on Operations.....	\$746,150.00	11.88%	\$619,500.00	10.41%	\$126,650.00	20.44
Net Financial Expense.....	94,575.00	1.50	73,500.00	1.24	21,075.00	28.67
Net Income Before Federal Income Tax.....	\$651,575.00	10.38%	\$546,000.00	9.17%	\$105,575.00	19.34

requisitions have amounted to. Each expenditure should be charged against the account representing the person who has the power to increase, decrease, or eliminate the expenditure. With such a classification, an intelligent study of operating results can be made, and responsibility for desirable and undesirable results can be definitely placed.

CHAPTER 58

PUBLIC ACCOUNTS

Governments and institutions.—Public accounts include accounts of (1) governments and subdivisions thereof, such as the national and state governments, counties, cities, villages, and park, drainage, and school districts; and (2) institutions, such as hospitals, libraries, and universities.

Sources of assets.—The assets recorded in public accounts are derived from the following principal sources:

- (1) Taxes and other revenues, including licenses, fees, fines, franchises, and service charges.
- (2) Loans, on bond issues or otherwise.
- (3) Assessments against property owners for improvements.
- (4) Grants from superior governments.
- (5) Gifts.

Funds.—The authorizations for the levying of taxes or assessments or for the issuance of bonds, stipulate the purposes for which the funds thus obtained may be used. Grants and gifts are usually received subject to definite limitations regarding the uses to be made thereof.

Since each fund is usually available for one designated purpose, it is imperative that a separate group of accounts be kept for each fund, showing the amount of its assets, the liabilities and commitments payable therefrom, and the amount of its surplus, or the excess of the assets over the liabilities and encumbrances of the fund.

The accounts of each fund constitute a complete accounting unit, from which a balance sheet can be prepared. This segregation of the accounts by funds is an important and peculiar feature of public accounts.

Classification of funds.—The following classification of funds is not exhaustive; it merely indicates the nature of

different funds:

- (I) Expendable funds:
 - (1) Revenue funds, derived from taxes or other revenue sources, and used for current operating activities:
 - (a) General fund—expendable for all general operating activities of the government or institution.
 - (b) Special fund—derived from revenues specifically raised for a particular purpose, such as a hospital, a library, or a park.
 - (2) Special assessment funds to be expended for local improvements, the cost of which will be charged, in whole or in part, to the owners of the property that is regarded as benefited by the improvement.
 - (3) Bond funds, arising from the sale of bond issues, and to be expended for public improvements.
- (II) Working capital or revolving funds, which, although expended, are replenished by the receipts from their operations.
- (III) Sinking funds for the payment of bond issues.
- (IV) Trust funds. These may be obtained from public or other sources, and are held for particular, designated purposes. Endowment funds, pension funds, and cemetery-care funds held by a city as custodian, are illustrations. Usually, only the income from such funds is expendable.

The nature of these various classes of funds will be clarified by the following discussion and by the illustrations of the accounts reflecting the operations of the funds.

In addition to the accounts with the various funds, a group of accounts should be maintained showing the fixed assets owned and the bond issues that are not direct obligations of particular funds.

The budget.—The operations of expendable revenue funds are controlled by the budget, which shows, with respect to each fund, the authorized estimated revenues and the

approved appropriations for expenditures. A well-prepared budget will usually contain:

Three principal statements (illustrated below):

A budget summary.

A schedule showing the estimated revenues classified by sources.

A schedule of appropriations classified by departments.

Numerous supporting statements, such as:

A statement comparing the estimated revenues for the current year and the actual revenues for previous years.

A statement comparing the appropriations for the current year and the appropriations for prior years.

A statement for each department, showing the appropriations classified according to the objects of the proposed expenditures, such as salaries, office expense, equipment, and repairs.

	Budget Summary		<u>Schedule A</u>
	<u>General Fund</u>	<u>Special Fund</u>	<u>Total</u>
Unexpended balance (if any) from preceding year, available for expenditure in current year	\$ —	\$ —	\$ —
Estimated revenues (Schedule B)	100,000	30,000	130,000
Total	<u>\$100,000</u>	<u>\$30,000</u>	<u>\$130,000</u>
Appropriations (Schedule C)	98,000	29,000	127,000
Unappropriated Surplus	<u>\$ 2,000</u>	<u>\$ 1,000</u>	<u>\$ 3,000</u>

	Estimated Revenues		<u>Schedule B</u>
<u>Sources</u>	<u>General Fund</u>	<u>Special Fund</u>	<u>Total</u>
Taxes	\$ 71,000	\$25,000	\$ 96,000
Licenses, fees, etc.	29,000	5,000	34,000
Total	<u>\$100,000</u>	<u>\$30,000</u>	<u>\$130,000</u>

	Appropriations		<u>Schedule C</u>
<u>Departments</u>	<u>General Fund</u>	<u>Special Fund</u>	<u>Total</u>
General Administration	\$ 30,000	\$20,000	\$ 50,000
Police Department	25,000	—	25,000
Public Welfare	8,000	—	8,000
Total	<u>\$ 98,000</u>	<u>\$29,000</u>	<u>\$127,000</u>

Outline of illustration.—The remainder of this chapter consists of illustrative transactions and general ledger entries therefor, applicable to the following typical funds of a municipality:

General fund.	Sinking fund.
Special fund.	Special assessment fund.
Stores fund.	Trust fund.
Bond fund.	Property.

Following the explanation of the entries in the general ledger accounts of each fund is a discussion of the subsidiary ledger accounts. Finally, the customary balance sheets and other statements are discussed.

To simplify the illustration, it will be assumed that, at the beginning of the period, there are no balances in any fund accounts, and that the only accounts open on the books of the municipality are the following:

Property (debit balance).....	\$1,000,000.00
Surplus Invested in Fixed Assets (credit balance)	1,000,000.00

These balances are shown, with the identifying number (1), in the summary (page 547) of the accounts of the Property section of the general ledger.

General Fund

Transactions.—A summary of the general ledger accounts of the General Fund appears on page 528; one column is devoted to each account; debit entries are unstarred; credit entries are starred. The entries for the transactions carry numbers that correspond to the numbers in the following statement of assumed facts:

(2) The total estimated revenues for the General Fund for the fiscal year, as shown by the budget on page 521, are \$100,000.00. Debit Estimated Revenues; credit Unappropriated Surplus.

(3) The total appropriations shown by the budget are \$98,000.00. Debit Unappropriated Surplus; credit Appropriations.

(4) The tax levy for General Fund purposes is \$75,000.00; it is estimated that \$3,000.00 of this amount will not be collected. Debit Taxes Receivable, \$75,000.00; credit Reserve

for Uncollectible Taxes, \$3,000.00; credit Estimated Revenues, \$72,000.00.

(5) Tax anticipation warrants amounting to \$30,000.00 are sold for cash at par. Debit Cash; credit Tax Anticipation Warrants Payable.

(6) Taxes in the amount of \$68,000.00 are collected. Debit Cash; credit Taxes Receivable.

(7) Tax anticipation warrants in the amount of \$20,000.00 are paid. Debit Tax Anticipation Warrants Payable; credit Cash.

(8) A loan of \$10,000.00 is made to the Special Fund. Debit Special Fund; credit Cash. (A contra entry in the accounts of the Special Fund is described later.)

(9) A fund is established for the purpose of purchasing stores to be furnished to all other funds as required by their operations; \$5,000.00 is transferred to this fund to provide it with working capital. Debit Stores Fund; credit Cash. (A contra entry in the accounts of the Stores Fund is described later.)

(10) Materials are requisitioned from the Stores Fund; the Stores Fund charges the General Fund \$1,000.00 for these materials. Debit Appropriations; credit Stores Fund. (A contra entry will be made in the accounts of the Stores Fund.)

(11) Cash is transferred to the Stores Fund in payment for these materials. Debit Stores Fund; credit Cash. (A contra entry will be made in the accounts of the Stores Fund.)

(12) Commitments are made in the form of orders and contracts in an estimated amount of \$20,000.00. These commitments are encumbrances against the appropriations; that is, they reduce the balance which may be used for other purposes; therefore, a memorandum record should be made of the amount thereof, by debiting Appropriation Encumbrances and crediting Reserve for Encumbrances.

(13) Certain materials ordered (see transaction 12) are received; two entries are required:

- (a) The estimated cost of the materials was \$14,000.00, and the memorandum entries for the commitment should be reversed. Debit Reserve for Encumbrances; credit Appropriation Encumbrances.

- (b) The invoice price of the materials is \$15,000.00, and vouchers for that amount are certified. Debit Appropriations; credit Vouchers Payable.

(14) Vouchers totaling \$14,000.00 are paid by warrants issued against the treasury. Practice differs regarding the accounting for warrants; two methods are in use:

First method: When warrants are issued by the accounting or disbursing department, debit Vouchers Payable and credit Cash.

Second method: When warrants are issued, debit Vouchers Payable and credit Warrants Payable. When paid vouchers are returned by the treasurer to the accounting department, debit Warrants Payable and credit Cash.

Under the first method of accounting, the cash is regarded as reduced immediately by the issuance of the warrant; under the second method, the cash is not regarded as reduced until the warrant has actually been presented to, and paid by, the treasurer. The first method is used in the illustrative entries.

(15) Some of the equipment owned at the beginning of the year is sold for \$2,000.00. This cash receipt is not a revenue receipt, but resulted from the conversion of an asset. It was not included in the estimated revenues for the period, and therefore it should not be credited to Estimated Revenues. Debit Cash; credit Surplus Receipts. (An entry for the cost of the property disposed of, to be made in the Property group of accounts, will be discussed later.)

(16) A cash payment of \$6,000.00 was made for the purchase of equipment; two General Fund entries are required:

- (a) For vouchers certified: debit Appropriations; credit Vouchers Payable.
- (b) For warrants issued: debit Vouchers Payable; credit Cash.

(Entries recording the cost of this property will also be made in the Property group of accounts.)

(17) A cash contribution of \$5,000.00 is made to a trust fund, the nature of which is more fully discussed in the

comments relative to the Trust Fund accounts. Debit Appropriations; credit Cash. (A contra entry in the Trust Fund accounts is described later.)

(18) A \$2,000.00 payment is made to the sinking fund. Debit Appropriations; credit Cash. (A contra entry will be found in the Sinking Fund accounts.)

(19) Cash in the amount of \$7,000.00 is received from the Special Fund, in partial repayment of the loan made to that fund (transaction 8). Debit Cash; credit Special Fund. (Contra entry in Special Fund accounts.)

It is often desired to prepare balance sheets at interim dates during the period; for the purpose of illustrating such a balance sheet, the balances in the General Fund accounts after transaction 19 are shown in the summary of these accounts on pages 528 and 529.

(20) Licenses, fees, and so forth, are collected in the amount of \$29,000.00. Debit Cash; credit Estimated Revenues.

(21) Additional vouchers are certified, as follows:

For previous encumbrances:

- (a) The original estimate of the encumbrances was \$4,000.00; reverse the memorandum entries by debiting Reserve for Encumbrances and crediting Appropriation Encumbrances.
- (b) The invoices received agree with the estimate; debit Appropriations and credit Vouchers Payable.
- (c) For miscellaneous expenses, amounting to \$56,000.00, for which no encumbrances had previously been recorded; debit Appropriations and credit Vouchers Payable.

(22) Warrants amounting to \$55,000.00 are issued in payment of vouchers. Debit Vouchers Payable; credit Cash.

(23) A special assessment fund (to be discussed in detail later) has been created for a local improvement; most of the cost of this improvement will be charged to the property owners; however, \$10,000.00 of the cost is to be paid from the general fund, as that portion of the cost is regarded as a public benefit; of this amount, \$5,000.00 is to be paid during

the current fiscal year. Provision for this expenditure was made in the budget of the General Fund, and the transfer of \$5,000.00 in cash to the Assessment Fund should be recorded by a debit to Appropriations and a credit to Cash. (Entries are also required in the Assessment Fund accounts and in the Property accounts.)

(24) A transfer of \$1,000.00 in cash is made to the Stores Fund to cover the loss in that fund for the year. Debit Appropriations; credit Cash. (Entry also required in Stores Fund accounts.)

The balances of the general ledger accounts for this fund, after these transactions have been recorded, are shown in the summary on pages 528 and 529.

General ledger and subsidiary accounts.—Before considering the closing entries to be made at the end of the period, it is desirable to comment on the nature of certain general ledger accounts and the subsidiary accounts which support them.

The Estimated Revenues account is debited at the beginning of the period with the total estimated revenues shown by the budget and credited during the period with revenues accrued (with taxes, when levied; with licenses and so forth, when collected). A debit balance indicates that the estimated revenues exceeded the actual revenues, and that the estimated surplus was thus reduced; a credit balance indicates that the actual revenues exceeded the estimates, and that the estimated surplus was thus increased. This account should be supported by a subsidiary ledger containing accounts with each class of revenue, which should be debited with the estimates and credited with the amounts accrued.

The Appropriations account is credited with the total of the appropriations shown by the budget and debited with expenditures made against the appropriations. Appropriation Encumbrances (with a debit balance) and Reserve for Encumbrances (with a credit balance) are memorandum accounts showing commitments made against appropriations. The Appropriations account and the Appropriation Encumbrances account are supported by a subsidiary ledger containing accounts with each department (General Administration, Police, Public Welfare, and so forth) for which appropriations

were made in the budget. The following illustration shows the money columns that should be provided; proper columns for Date, Reference, Name, and so forth, should appear at the left.

General Fund Appropriation for Police Department

	ENCUMBRANCES			APPROPRIATIONS		
	Debit	Credit	Balance	Debit	Credit	Balance
			Dr.—Cr.*			Dr.—Cr.*
Budget appropriation					\$25,000	\$25,000*
Orders placed	\$1,000		\$1,000			
Vouchers issued		\$800	200	\$ 850		24,150*
Vouchers issued				3,000		21,150*

The subsidiary account illustrated shows a balance of \$21,150.00 in the appropriation for the Police Department; this balance is subject to an encumbrance of \$200.00; therefore the net available balance is \$20,950.00. The credit balance in the Appropriations account in the general ledger should agree with the total of all credit balances in the Appropriations section of the subsidiary accounts applicable to the fund; and the debit balance in the Appropriation Encumbrances account in the general ledger should agree with the sum of the debit balances in the Encumbrances section of the subsidiary accounts.

Each departmental Appropriations account in the subsidiary ledger is in turn supported by an account in an expenditure analysis ledger, in which the charges against appropriations are classified according to the object of the expenditure. For example, the subaccount with Police Department Appropriations might be supported by the following expenditure account:

**General Fund—Police Department
Analysis of Expenditures**

	Salaries	Office Expense	Supplies	Etc.	Etc.	Total
January (Summary)	\$3,000	\$300	\$550			\$3,850

It will be noted that the total debits of \$3,850.00 agree with the total debits in the Appropriations account for the police department. These accounts in the expenditure analysis ledger furnish the information for the periodical statements of expenditures.

The nature of the Tax Anticipation Warrants Payable and

General Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Taxes Receivable	Reserve for Uncol- lectible Taxes	Special Fund	Stores Fund	Estimated Revenues	Vouchers Payable	Tax Anticipation Warrants Payable	Appropriation Encumbrances	Reserve for Encum- brances	Appropriations	Surplus Receipts	Unappropriated Surplus
(2) Total estimated revenues—per budget.....						100					98*		100*
(3) Total appropriations—per budget.....						72*					98*		98
(4) Tax levy.....		75	3*										
(5) Tax anticipation warrants sold.....	30							30*					
(6) Taxes collected.....	68	68*											
(7) Tax anticipation warrants paid.....	20*							20					
(8) Loan to Special Fund.....	10*			10									
(9) Advance to Stores Fund.....	5*												
(10) Materials requisitioned from Stores Fund.....					5						1		
(11) Cash transferred to Stores Fund in payment of materials	1*				1*								
(12) Contracts made and orders placed.....					1				20	20*			
(13) Liabilities on vouchers certified:													
(a) Estimated encumbrance—reversed.....													
(b) Vouchers certified.....							15*		14*	14	15		
(14) Warrants issued.....	12*						12						
(15) Receipts from sale of equipment.....													
(16) Purchase of equipment:	2												
(a) Vouchers certified.....													
(b) Warrants issued.....	6*						6*				6		
(17) Contribution to Trust Fund.....	5*												5

the Vouchers Payable accounts is obvious; they should be supported by subsidiary registers.

The credit balance in the Surplus Receipts account represents the increase in surplus arising from sources other than revenues.

The Unappropriated Surplus account balance shows the (estimated during the period, actual at the end of the period) difference between revenues and appropriations.

Closing the accounts.—Entries closing certain accounts of the General Fund are shown in the summary on page 529.

The Reserve for Uncollectible Taxes is found to be excessive; as the estimated revenues were therefore understated, the reserve is adjusted by debiting Reserve for Uncollectible Taxes and crediting Estimated Revenues.

After this adjustment has been made, the Estimated Revenues account has a credit balance of \$2,000.000, which shows that the actual revenues were greater than the estimated revenues; therefore, the estimated surplus was understated during the period. Debit Estimated Revenues, to close; credit Unappropriated Surplus.

The credit balance in Surplus Receipts represents an addition to Surplus; the account is therefore closed by transfer to Unappropriated Surplus.

Appropriations not expended or encumbered at the end of the period usually lapse; therefore the unencumbered balance of appropriations (\$3,000.00 credit balance in Appropriations, minus \$2,000.00 debit balance in Appropriation Encumbrances) is closed to Unappropriated Surplus.

The summary on page 529 shows the balances in the General Fund accounts after the foregoing closing entries have been made. These balances are carried forward to the accounts for the succeeding period.

Special Fund

Transactions.—The precise nature of this fund is of no significance; it should be regarded as applicable to some particular operating activity, such as a park or a library. Reference numbers appearing below in other than numerical sequence refer to transactions already mentioned in connection with the General Fund. The summary of the general ledger

accounts for the Special Fund appears on page 532.

(25) The total estimated revenue for the Special Fund for the fiscal year, as shown by the budget on page 521, was \$30,000.00. Debit Estimated Revenues; credit Unappropriated Surplus.

(26) The total appropriations shown by the budget were \$29,000.00. Debit Unappropriated Surplus; credit Appropriations.

(27) The tax levy for Special Fund purposes is \$25,000.00; it is estimated that \$1,000.00 of this amount will not be collectible. Debit Taxes Receivable, \$25,000.00; credit Reserve for Uncollectible Taxes, \$1,000.00, and Estimated Revenues, \$24,000.00.

(8) A loan of \$10,000.00 is received from the General Fund. Debit Cash; credit General Fund. (Contra entry in General Fund accounts.)

(28) Tax collections amount to \$22,000.00. Debit Cash; credit Taxes Receivable.

(29) Materials that cost \$2,000.00 are requisitioned from the Stores Fund. Debit Appropriations; credit Stores Fund. (Contra entry will be made in Stores Fund accounts.)

(30) Cash is transferred to the Stores Fund in payment for the materials. Debit Stores Fund; credit Cash. (Contra entry will be made in Stores Fund accounts.)

(31) Contracts are made and orders are placed in an estimated amount of \$12,000.00. Debit Appropriation Encumbrances; credit Reserve for Encumbrances.

(32) Vouchers are certified for liabilities applicable to prior encumbrances.

(a) Estimated amount of encumbrances, \$10,000.00; debit Reserve for Encumbrances and credit Appropriation Encumbrances.

(b) Vouchers certified, \$9,000.00; debit Appropriations and credit Vouchers Payable.

(33) Warrants are issued in the amount of \$7,000.00 in payment of vouchers. Debit Vouchers Payable; credit Cash.

(19) A transfer of \$7,000.00 is made to the General Fund in partial repayment of the loan. Debit General Fund; credit Cash. (Contra entry in General Fund accounts.)

The balances in the accounts at this point are shown in the

Special Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Taxes Receivable	Reserve for Un- collectible Taxes	Estimated Revenues	Vouchers Payable General Fund	Stores Fund	Appropriation Encumbrances	Reserve for Encumbrances Appropriations	Unappropriated Surplus	
(25) Total estimated revenue—per budget.....				30					30*	
(26) Total appropriations—per budget.....								29*	29	
(27) Tax levy		25	1*	24*						
(8) Loan from General Fund	10				10*					
(28) Taxes collected	22	22*								
(29) Materials requisitioned from Stores Fund.....						2*		2		
(30) Cash transferred to Stores Fund in payment for materials	2*					2				
(31) Contracts made and orders placed							12	12*		
(32) Liabilities on vouchers certified:										
(a) Estimated encumbrances—reversed...							10*	10		
(b) Vouchers certified.....					9*			9		
(33) Warrants issued.....	7*				7					
(19) Partial repayment of loan from General Fund.....	7*				7					
Balances at a date during the period	16	3	1*	6	2*	3*	2	2*	18*	1*
(34) Licenses, fees, etc., collected..	5			5*						
(35) Additional vouchers certified:										
For previous encumbrances:										
(a) Reverse encumbrances							1*	1		
(b) Vouchers certified....					1*			1		
(c) For miscellaneous expenses.....					15*			15		
(36) Warrants issued	14*				14					
Final Balances—before Closing....	7	3	1*	1	4*	3*	1	1*	2*	1*
Closing Entries:										
Close Estimated Revenues.....				1*					1	
Close unencumbered balance of Appropriations.....								1	1*	
Balances after Closing—Carried to Next Fiscal Year.....	7	3	1*		4*	3*	1	1*	1*	1*

* Credit.

above summary, and are used in the illustration of a balance sheet prepared during the fiscal period.

(34) Licenses, fees, and so forth, are collected in the amount of \$5,000.00. Debit Cash; credit Estimated Revenues.

(35) Additional vouchers are certified, as follows:

For previous encumbrances:

- (a) Estimated encumbrances, \$1,000.00; debit Reserve for Encumbrances and credit Appropriation Encumbrances.
- (b) Vouchers certified, \$1,000.00; debit Appropriations and credit Vouchers Payable.
- (c) For miscellaneous expenses not represented by previous encumbrances: amount of vouchers certified, \$15,000.00; debit Appropriations and credit Vouchers Payable.

(36) Warrants are issued in payment of vouchers in the amount of \$14,000.00. Debit Vouchers Payable; credit Cash.

Closing entries.—The balances before closing are shown in the summary; the following closing entries are made at the end of the fiscal period:

The Estimated Revenues account has a debit balance of \$1,000.00, representing the excess of estimated over actual revenues; this debit balance is closed to Unappropriated Surplus.

There is a \$2,000.00 credit balance in the Appropriations account, and a \$1,000.00 debit balance in the Appropriation Encumbrances account; hence the unencumbered balance of appropriations is \$1,000.00; as the appropriation now lapses, debit Appropriations and credit Unappropriated Surplus.

The summary shows the account balances after these closing entries have been made; these balances are carried forward to the Special Fund accounts for the succeeding period.

Stores Fund

Transactions.—A fund is established to centralize the purchasing of supplies, which are issued to the other funds upon requisitions. Theoretically, the stores should be issued at cost, including a pro-rated share of the expense of operation; actually, a surplus or deficit may develop, which should be taken up by the general fund. The receipts and expenditures of the fund cannot be easily estimated; therefore no budget will be prepared, and the accounts of the fund will not be opened by a debit to Estimated Revenues and a credit to Appropriations.

(9) Cash is transferred to this fund from the General Fund, to provide working capital for Stores Fund operations. Debit Cash; credit General Fund. (Contra entry in General Fund accounts.)

(37) Orders are issued for the purchase of stores. Debit Store Encumbrances; credit Reserve for Encumbrances.

(38) Stores are received, and vouchers therefor are certified:

- (a) The estimated amount of the encumbrances applicable to these invoices was \$4,000.00; reverse the memorandum entries by debiting Reserve for Encumbrances and crediting Store Encumbrances.
- (b) The actual amount of the invoices was also \$4,000.00; debit Stores and credit Vouchers Payable.

(10) Stores are issued to the General Fund on requisition. Debit General Fund; credit Stores. (Contra entry in General Fund accounts.)

(29) Stores are issued to the Special Fund on requisition. Debit Special Fund; credit Stores. (Contra entry in Special Fund accounts.)

(11) Cash is received from the General Fund in payment for the materials. Debit Cash; credit General Fund. (Contra entry in General Fund accounts.)

(30) Cash is received from the Special Fund in payment for the materials. Debit Cash; credit Special Fund. (Contra entry in the Special Fund accounts.)

The balances in the accounts at this point are shown in the summary on page 535 ; they are used to illustrate a balance sheet prepared during the fiscal period.

(39) Vouchers are certified for freight, handling, and other expenses. Since all expenses of operating this fund may be considered costs of the stores issued to the other funds, debit Stores and credit Vouchers Payable.

(40) Additional stores are purchased and received. Debit Stores; credit Vouchers Payable.

(41) A physical inventory shows that the cost of the stores on hand is \$1,000.00 less than the balance of the Stores

account. Debit Surplus; credit Stores.

(24) The working capital of the Stores Fund was impaired by the inventory shortage, and cash is received from the General Fund to replenish it. Debit Cash; credit Surplus. (Accompanying entry in General Fund accounts.)

The balances in the Stores Fund accounts, after these transactions have been recorded, are shown in the following summary. There are no closing entries; all balances are carried forward to the next fiscal period.

Stores Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Special Fund	Stores	Stores Encumbrances	Vouchers Payable	Reserve for Encumbrances	General Fund	Surplus
(9) Cash received from General Fund for working capital.....	5						5*	
(37) Orders issued for stores.....				6		6*		
(38) Liability for vouchers certified:								
(a) Estimated encumbrances—reversed..				4*		4		
(b) Vouchers certified.....			4		4*			
(10) Stores issued to General Fund.....			1*				1	
(29) Stores issued to Special Fund.....		2	2*					
(11) Cash received from General Fund in payment for stores.....	1						1*	
(30) Cash received from Special Fund in payment for stores.....		2	2*					
Balances at a date during the period.....	8		1	2	4*	2*	5*	
(39) Freight, handling, and other expenses . . .			1		1*			
(40) Purchases.....			7		7*			
(41) Adjustment of Stores account to physical inventory.....				1*				1
(24) Cash from General Fund to cover shortage of Stores.....	1							1*
Final Balances—Carried to next fiscal year . . .	9	8	2	12*	2*	5*		

* Credit.

Bond Fund

Transactions.—The accounts of bond funds are intended to show the disposition of the proceeds of bonds issued for capital purposes, such as the construction of a bridge or a building. The bonds are not shown as liabilities of the fund, because they are not to be paid from the proceeds of the bonds; the property constructed is not shown as an asset of the fund, because it is not available for further expenditure. The fixed assets acquired and the bond liability are shown in the accounts in the Property section of the general ledger.

If bonds are issued for special, non-capital purposes, such as the payment of a soldier's bonus, Bond Fund accounts should be opened, to show the proceeds of the issue and the disposition thereof.

(42) Bonds of a par value of \$100,000.00 are authorized. Debit Bonds Authorized and Unissued; credit Unappropriated Balance. (See accompanying entry in Property accounts.)

(43) Bonds of a par value of \$75,000.00 are sold for \$78,000.00. If bonds are issued for the construction of assets to be used in some revenue-producing activity such as a municipally operated utility, the premium should be set up and amortized, so that true interest costs can be charged against the subsequent operations. In other cases the premium may be regarded merely as an addition to the amount available for expenditure, and the effect upon interest costs may be ignored; it is so treated in the illustration. Debit Cash, \$78,000.00; credit Bonds Authorized and Unissued, \$75,000.00, and Unappropriated Balance, \$3,000.00.

(44) A total of \$99,000.00 is appropriated for expenditure for the purpose for which the bonds were issued. Debit Unappropriated Balance; credit Appropriations.

(45) A construction contract is signed; the estimated cost is \$90,000.00. Debit Appropriation Encumbrances; credit Reserve for Encumbrances.

(46) As the work progresses, progress payments are made:

(a) For the estimated portion of the contract completed: Debit Reserve for Encumbrances; credit Appropriation Encumbrances.

(b) For vouchers certified: Debit Appropriations; credit Vouchers Payable.

(47) Warrants are issued in payment of vouchers. Debit Vouchers Payable; credit Cash.

The balances in the accounts at this point are shown in the summary on page 537; they are used in the illustrative interim balance sheet.

(48) The remaining bonds, of a par value of \$25,000.00, are sold for \$24,000.00. Debit Cash, \$24,000.00, and Unappropriated Balance, \$1,000.00; credit Bonds Authorized and Unissued, \$25,000.00.

(49) The construction contract is completed:

- (a) Close the memorandum accounts with encumbrances; debit Reserve for Encumbrances and credit Appropriation Encumbrances.
- (b) Record the certification of vouchers; debit Appropriations and credit Vouchers Payable.

(50) Vouchers are certified for other expenses totaling \$10,000.00. Debit Appropriations; credit Vouchers Payable.

(51) Warrants are issued in payment of all certified vouchers. Debit Vouchers Payable; credit Cash.

The balances in the general ledger accounts of this fund, after the completion of the contract, are shown in the summary below.

Bond Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Bonds Authorized and Unissued	Vouchers Payable	Appropriation Encumbrances	Reserve for Encumbrances	Appropriations	Unappropriated Balance
(42) Bonds authorized.....		100					100*
(43) Bonds sold at a premium.....	78	75*					3*
(44) Appropriation for purpose of fund.....						99*	99
(45) Contract signed.....				90	90*		
(46) Vouchers certified for progress payments:							
(a) Estimated encumbrance—reversed.....				45*	45		
(b) Vouchers certified.....			45*			45	
(47) Warrants issued.....	40*		40				
Balances before completion.....	38	25	5*	45	45*	54*	4*
(48) Remaining bonds sold at a discount.....	24	25*					1
(49) Contract completed:							
(a) Encumbrances reversed.....				45*	45		
(b) Vouchers certified.....			45*			45	
(50) Vouchers certified for other expenses.....			10*			10	
(51) Warrants issued in full payment of vouchers..	60*		60				
Balances after completion.....	2					1	3*
Closing entries:							
Close Appropriations.....						1*	1
(52) Transfer remaining cash to Sinking Fund..	2*						2
Balances.....	—	—	—	—	—	—	—

* Credit.

General ledger and subsidiary accounts.—The Appropriations, Appropriation Encumbrances, and Reserve for Encumbrances accounts are similar to those discussed under the

General Fund, and are supported by similar subsidiary records. The nature of the Bonds Authorized and Unissued account is obvious. The Unappropriated Balance account is credited with the par of the bonds authorized, and debited and credited with items which decrease or increase the amount available for expenditure; it is debited with the appropriations; its balance therefore represents the unappropriated resources of the fund.

Closing the accounts.—As shown by the summary on page 537, the Appropriations account has a debit balance of \$1,000.00, indicating that the expenditures were in excess of the appropriation; this balance is transferred to the debit of Unappropriated Balance.

(52) The Cash account now has a debit balance of \$2,000.00, and the Unappropriated Balance account has a credit balance of the same amount. The unexpended cash is transferred to the sinking fund for the payment of the bonds, and the accounts of the Bond Fund are closed by debiting Unappropriated Balance and crediting Cash. (Contra entry in Sinking Fund accounts.)

Sinking Fund

Transactions.—The accounts of this group show the provision for, and payment of, the interest and principal of bonds and other funded debt. The illustration relates to the \$100,000.00 of bonds dealt with in the preceding discussion of the Bond Fund.

(53) At the beginning of the period, or at the time of the issuance of the bonds, entries should be made showing the amount which must be provided in the sinking fund during the year, to meet principal and interest requirements. In the illustration, it is assumed that \$10,000.00 must be provided for principal and \$6,000.00 for interest. Debit Sinking Fund Requirements, \$16,000.00; credit Reserve for Retirement of Bonds, \$10,000.00, and Reserve for Bond Interest, \$6,000.00.

(18) A portion of the requirements is met by a transfer of \$2,000.00 from the General Fund. Debit Cash; credit Sinking Fund Requirements. (Contra entry in General Fund accounts.)

(54) The special tax levy for sinking fund purposes is recorded by debiting Taxes Receivable, \$14,000.00, and crediting Reserve for Uncollectible Taxes, \$1,000.00, and Sinking Fund Requirements, \$13,000.00.

(55) Taxes are collected in the amount of \$10,000.00. Debit Cash; credit Taxes Receivable.

(56) Securities are purchased. Debit Investments; credit Cash. If securities are purchased with the intention of holding them until the maturity of the bond liability, any premium or discount may be set up and amortized.

(57) Interest in the amount of \$1,000.00 is collected on sinking fund investments. Debit Cash; credit Income.

(58) Securities are sold. Debit Cash; credit Investments. Any profit or loss on sales of securities may be taken up in the Income account.

(59) Bond interest for a half year is paid:

(a) Debit Reserve for Bond Interest; credit Appropriations.

(b) Debit Appropriations; credit Cash.

The balances in the accounts at this point are shown in the summary, and appear in the illustrative interim balance sheet.

(52) The unexpended cash in the Bond Fund was transferred to the Sinking Fund. Debit Cash; credit Sinking Fund Requirements. (Accompanying entry in Bond Fund accounts.)

(60) Bonds of a par value of \$5,000.00 are retired:

(a) Debit Reserve for Retirement of Bonds; credit Appropriations.

(b) Debit Appropriations; credit Cash.

(Since the bond liability is shown in the Property group of accounts, an entry for the retirement of the bonds is also required in that group of accounts.)

The balances in the accounts at the end of the fiscal year, before closing entries are made, are shown in the summary on page 540.

General ledger and subsidiary accounts.—A debit balance at any time in the Sinking Fund Requirements account shows

Sinking Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Taxes Receivable	Reserve for Un- collectible Taxes	Investments	Sinking Fund Requirements	Reserve for Retire- ment of Bonds	Reserve for Bond Interest	Appropriations	Income	Surplus
(53) Requirements for the fiscal year					16	10*	6*			
(18) Received cash from General Fund	2				2*					
(54) Tax levy for the year		14	1*		13*					
(55) Taxes collected	10	10*								
(56) Securities purchased	11*			11						
(57) Income on securities	1								1*	
(58) Securities sold	8			8*						
(59) Bond interest paid:										
(a) Appropriation							3	3*		
(b) Payment	3*							3		
Balances at a date during the period	7	4	1*	3	1	10*	3*		1*	
(52) Cash transferred from Bond Fund	2				2*					
(60) Bonds paid:										
(a) Appropriation						5		5*		
(b) Warrants issued	5*							5		
Balances at end of fiscal year before closing	4	4	1*	3	1*	5*	3*		1*	
Closing Entries:										
Close Income to Sinking Fund Re- quirements					1*				1	
Close Sinking Fund Requirements to Surplus					2					2*
Balances after closing—Carried for- ward to next fiscal year	4	4	1*	3		5*	3*			2*

* Credit.

that resources equal to the requirements for the period have not yet been received; a credit balance indicates that the assets received have exceeded the requirements.

The nature of the Cash, Taxes Receivable, Reserve for Uncollectible Taxes, Investments, and Income accounts is obvious. The two Reserve accounts show the prospective disposition of sinking fund assets during the period; when actual dispositions are made, this account is debited and Appropriations is credited.

If there are several sinking funds, applicable to different bond issues, all of the general ledger accounts should be supported by subsidiary records showing the facts with respect to each fund. If the investments of several funds are pooled, the subsidiary Investment record will show the investments in detail, but without allocation by funds.

Closing entries.—The Income account (see summary on page 540) has a credit balance of \$1,000.00; this balance is transferred to the credit of Sinking Fund Requirements, because the income collected helped to meet the sinking fund requirements. After this entry is made, the Sinking Fund Requirements account has a credit balance of \$2,000.00, which represents the excess of resources obtained by the fund over its requirements for the period—in other words, the surplus of the fund. Therefore the balance in the Sinking Fund Requirements account is closed to the credit of Surplus.

Special Assessment Fund

Transactions.—Special assessment funds, frequently found in the accounts of municipalities, arise generally from the sale of local improvements bonds. The proceeds are expended for the improvement; the cost thereof is charged back to the property owners, or in part to the city as a public benefit; and the bonds and interest are paid from the collections from the property owners and the city. Since the bonds are paid from collections received by the fund, they are shown as a liability of the fund.

(61) A \$50,000.00 expenditure for a local improvement is approved. Debit Available Authorization; credit Unencumbered Balance.

(62) Bonds of a par value of \$50,000.00 are authorized. Debit Bonds Authorized and Unissued; credit Bonds Payable.

(63) Bonds of a par value of \$40,000.00 are sold for \$41,000.00; the premium realized increases the available balance of the fund. Debit Cash, \$41,000.00; credit Bonds Authorized and Unissued, \$40,000.00 and Unencumbered Balance, \$1,000.00.

(64) A contract for the improvement is signed; the estimated cost is \$45,000.00. Debit Unencumbered Balance; credit Reserve for Encumbrances.

(65) Vouchers for miscellaneous costs and expenses, totaling \$5,000.00, are certified. Debit Unencumbered Balance; credit Vouchers Payable.

(66) Warrants for \$3,000.00 are issued against vouchers certified:

(a) Debit Vouchers Payable; credit Cash.

(b) Since the expenditures from this fund are

recoverable by charges to the property owners and the city, debit Reimbursable Expenditures and credit Available Authorization.

The balances in the accounts at this point are shown in the summary on page 543, and appear in the illustrative interim balance sheet.

(67) The remaining bonds are sold at par. Debit Cash; credit Bonds Authorized and Unissued.

(68) Vouchers are certified for the completed contract, at a cost of \$45,000.00. Debit Reserve for Encumbrances; credit Vouchers Payable.

(69) Warrants are issued for all certified vouchers.

- (a) Record the payment by debiting Vouchers Payable and crediting Cash, \$47,000.00.
- (b) Record the amount reimbursable by debiting Reimbursable Expenditures and crediting Available Authorization, \$47,000.00.
- (c) The contract is now completed and all expenditures have been made. The Unencumbered Balance account has a credit balance of \$1,000.00, representing the surplus of the fund, and this balance is transferred to Surplus. Any losses on, or abatements of, assessments may subsequently be charged against this surplus balance.

(70) The expenditures from the fund totaled \$50,000.00; of this amount, \$40,000.00 is assessed against property owners, and \$10,000.00 is regarded as a public benefit. Debit Assessments Receivable, \$40,000.00, and Public Benefit, \$10,000.00; credit Reimbursable Expenditures, \$50,000.00. This entry closes the last-named account.

(23) A collection of \$5,000.00 is received from the General Fund to apply against the amount assessed as a public benefit. Debit Cash; credit Public Benefit. (The accompanying General Fund entry is: Debit Appropriations; credit Cash. An entry will also be made in the Property account section of the ledger, debiting Property and crediting Surplus Invested in Fixed Assets, \$5,000.00.)

(71) An assessment installment of \$15,000.00, with

Assessment Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Bonds Authorized and Unissued	Reimbursable Expenditures	Available Authorization	Assessments Receivable	Public Benefit	Interest	Vouchers Payable	Bonds Payable	Reserve for Encumbrances	Unencumbered Balance	Surplus
(61) Expenditure approved.....				50					50*		50*	
(62) Bonds authorized.....		50										
(63) Bonds sold at a premium.....		40*									1*	
(64) Contract signed.....	41							5*		45*	45	
(65) Vouchers certified for expenses.....											5	
(66) Warrants issued:												
(a) Entry for payment.....	3*		3	3*				3				
(b) Reimbursable expenditure.....			3	3*								
Balances at a date during the period.....	<u>38</u>	<u>10</u>	<u>3</u>	<u>47</u>	-	-	-	<u>2*</u>	<u>50*</u>	<u>45*</u>	<u>1*</u>	-
(67) Remaining bonds sold at par.....	10	10*						45*		45		
(68) Vouchers certified for completed contract.....												
(69) Warrants issued in final payment:												
(a) Entry for payment.....	47*		47	47*				47				
(b) Reimbursable expenditures.....												
(c) Close Unencumbered Balance to Surplus.....			50*		40	10					1	1*
(70) Assessment.....						5*						
(71) Collection from General Fund.....	5				15*		1*					
(72) Assessments and interest collected.....	16						3					
(73) Bond interest paid.....	3*											
(74) Bonds paid.....	5*											
Balances at end of period.....	<u>14</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>25</u>	<u>5</u>	<u>2</u>	<u>-</u>	<u>5</u>	<u>-</u>	<u>-</u>	<u>1*</u>

* Credit.

\$1,000.00 interest thereon, is collected. Debit Cash, \$16,000.00; credit Assessments Receivable, \$15,000.00, and Interest, \$1,000.00.

(72) Bond interest totaling \$3,000.00 is paid. Debit Interest; credit Cash.

(73) Bonds of a par value of \$5,000.00 are paid. Debit Bonds Payable; credit Cash.

The account balances carried over to the next fiscal period are shown in the summary on page 543.

General ledger and subsidiary accounts.—It is believed that the nature of all general ledger accounts illustrated is obvious. It should be understood that separate subsidiary accounts should be maintained with each special assessment fund, so that there may be no danger of confusion and misapplication of funds.

If, after a particular fund has been closed by the final payment of the bonds, a balance remains in the Surplus account, theoretical propriety would require a distribution of the residue of the fund to the property owners and to the General Fund in proportion to the assessment and public benefit charges paid by them. As such a distribution is usually impracticable, the excess is generally transferred to other assessment funds or to the General Fund.

Trust Fund

Transactions.—Endowment funds, pension funds, and other trust funds may be received by gift or by appropriation of public funds. Usually only the income is expendable.

(74) A gift of \$45,000.00 is received in cash for the creation of a special-purpose trust fund. The gift is conditional upon the appropriation of an additional \$5,000.00 from the public treasury, and only the income from the fund is to be expended. For the \$45,000.00 gift: debit Cash; credit Permanent Balance.

(17) Cash in the amount of \$5,000.00 is transferred from the General Fund. Debit Cash; credit Permanent Balance. (Contra entry in General Fund accounts.)

(75) Securities are purchased for the fund:

(a) For vouchers certified: Debit Investments;

credit Vouchers Payable.

- (b) For warrants issued: Debit Vouchers Payable; credit Cash.

If securities are purchased at a premium for a fund of which only the income is expendable, the premium should be amortized against income.

(76) Income is collected. Debit Cash; credit Expendable Balance.

(77) Expenditures are made for the purpose for which the fund was created:

- (a) For vouchers certified: Debit Expendable Balance; credit Vouchers Payable.
- (b) For warrants issued: Debit Vouchers Payable; credit Cash.

The summary of the general ledger accounts is shown below.

Trust Fund
Summary of General Ledger Accounts
(000 Omitted)

	Cash	Investments	Vouchers Payable	Permanent Balance	Expendable Balance
(74) Gift received.....	45			45*	
(17) Contribution from General Fund.....	5			5*	
(75) Purchase of securities:					
(a) Vouchers certified.....		45	45*		
(b) Warrants issued.....	45*		45		
(76) Income collected.....	3				3*
(77) Expenditures:					
(a) Vouchers certified.....			2*		2
(b) Warrants issued.....	2*		2		
Balances at a date during (and also at the end of)					
the period.....	6	45	—	50*	1*

* Credit.

General ledger and subsidiary accounts.—The nature of all general ledger accounts in the Trust Fund group is obvious. If there are several trust funds, one group of general ledger accounts will be sufficient, but all of these general ledger accounts should be supported by similar subsidiary accounts for each fund.

Property Accounts

Transactions.—The Property, Fixed Assets, or Plant Capital group of accounts shows the cost of fixed assets owned and not appertaining to any fund; the capital liabilities which are not obligations of particular funds; and the excess of such assets over such liabilities, or the surplus invested in fixed assets.

Fixed assets are customarily carried at cost, and are not subjected to depreciation charges, because: (a) No profit and loss statement is prepared (except for utilities, such as water or light plants operated by a city; fixed assets applicable to such plants should be depreciated). (b) There would be no justification for the charge unless it were desired to create a replacement fund by including a provision therefor in the budget; but this would be undesirable because fixed assets are usually purchased from the proceeds of bond issues, and are paid for by assessments subsequent to acquisition. The inclusion of both the sinking fund requirements and a depreciation fund requirement in the same budget would involve a double charge upon the same taxpayers.

(1) The summary on page 547 shows the condition at the beginning of the period, reflected by the debit balance in the Property account and the credit balance in Surplus Invested in Fixed Assets.

(15) Certain property which cost \$10,000.00 was disposed of. Debit Surplus Invested in Fixed Assets; credit Property. (The proceeds of the sale, \$2,000.00, were taken up in the General Fund. The \$8,000.00 loss is nowhere recorded.)

(16) Equipment was purchased with General Fund Cash. Debit Property; credit Surplus Invested in Fixed Assets. (Contra entry in General Fund accounts.)

(42) Bonds of a par value of \$100,000.00 were authorized for a public improvement. Debit Improvements in Progress; credit Bonds Payable. (Contra entry in Bond Fund accounts.)

The balances shown in the accounts at this point are assumed to reflect the condition at the date of the illustrative interim balance sheet.

(23) A payment of \$5,000.00, representing the portion of the cost of the local improvement that is regarded as a public

benefit, was made from the General Fund to the Assessment Fund. Debit Property; credit Surplus Invested in Fixed Assets. (Accompanying entries in the General Fund and Assessment Fund accounts.)

(78) The public improvement for which bonds were issued (transaction 42) has been completed. Its cost, as shown by the accounts of the Bond Fund, was \$100,000.00. Debit Property; credit Improvements in Progress. Any difference between the cost of the completed improvement and the par of the bonds issued therefor, would be recorded in Surplus.

(60) Bonds of a par value of \$5,000.00 (authorized in transaction 42) have been retired by payments from the sinking fund. Debit Bonds Payable; credit Surplus Invested in Fixed Assets. (Accompanying entry in Sinking Fund accounts.)

The balances at the end of the period are shown in the following summary.

Property Accounts
Summary of General Ledger Accounts
(000 Omitted)

	Property	Improvements in Progress	Bonds Payable	Surplus Invested in Fixed Assets
(1) Opening balances.....	1,000			1,000*
(15) Cost of property disposed of.....	10*			10
(16) Cost of equipment purchased with General Fund cash.....	6			6*
(42) Bonds authorized for public improvement		100	100*	
Balances at a date during the period.....	996	100	100*	996*
(23) Payment by General Fund to Assessment Fund for portion of local improvement cost regarded as public benefit.....	5			5*
(78) Total cost of improvement paid from Bond Fund.....	100	100*		
(60) Bonds paid from Sinking Fund.....			5	5*
Balance at end of fiscal period.....	1,101	—	95*	1,006*

* Credit.

General ledger and subsidiary accounts.—Complete subsidiary records should be maintained showing the cost of each separate unit of property, and the amount of liability on each bond issue.

Statements

So many different statements may be prepared to reflect the operation and condition of the various funds, that it is impracticable to attempt to do more than mention and illustrate some of the more important statements.

Statement of realization of revenues.—From time to time during, as well as at the end of, the period, it is desirable to prepare a statement showing the relation of revenue accruals to revenue estimates, and of revenue collections to revenue accruals. Such a statement may be prepared in the following form:

Statement of Realization of Revenues
From To

	Estimate Per Budget (a)	ACCRUED			Not Accrued (e)	Collected (f)	Not Collected (g)
		Total (b)	Reserve (c)	Net (d)			
General Fund: Taxes Licenses Etc. Total	Amounts shown by debits in subsidiary revenue ledger accounts.	Taxes, from debit to Taxes Receivable in general ledger; other amounts from credits to accounts in subsidiary revenue ledger.	Amount shown by credit to Reserve account in general ledger.	(b) - (c).	(a) - (d).	Shown by cash records.	(d) - (f).
Special Fund: Taxes Licenses Etc.							

Statement of appropriations.—Departmental executive officers should be kept informed of the status of appropriations for their departments. This can be most easily accomplished by providing them at intervals with copies of the departmental subsidiary appropriation accounts (General Administration, Police Department, and so forth; see page 527). A summary may be prepared as follows:

Summary of Appropriations

From To

	Appropriations (a)	Expenditures (b)	Unexpended Balance (c)	Encumbrances (d)	Unencumbered Balance (e)
General Fund: General Administration Police Department Etc. Total	Amounts shown by credits in subsidiary appropriation ledger. (See page 527.)	Amounts shown by debits in subsidiary appropriation ledger. (See page 527.)	(a) — (b).	Amounts shown by debits in Encumbrances column of subsidiary appropriation ledger accounts. (See page 527.)	(c) — (d).
Special Fund: General Administration Etc. Total					

Balance sheets.—A balance sheet may be prepared for each fund and for the property accounts. The illustration on pages 550 and 551 shows a consolidated balance sheet prepared at a date during the period. The illustration on page 552 shows the account balances at the end of the period. Either form illustrated could be used for either an interim or a final balance sheet.

It should be noted that the amount shown as Appropriations in each section of the balance sheet is the difference between the credit balance in the Appropriations account and the debit balance in the Appropriation Encumbrances account.

The illustrations do not show the treatment of a funded deficit in a revenue fund. If it becomes necessary to issue bonds because of an accumulated deficit, the entries are: (1) debit Cash, credit Revenue Bonds; and (2) debit Funded

Consolidated Fund Balance Sheet
(At a Date During the Fiscal Year)

Assets		Liabilities and Surplus	
GENERAL FUND:		GENERAL FUND:	
Cash.....	\$ 46,000	Vouchers Payable.....	\$ 3,000
Taxes Receivable.....	\$7,000	Tax Anticipation Warrants Payable.....	10,000
Less Reserve for Loss.....	<u>3,000</u>	Reserve for Encumbrances.....	6,000
Due from Other Funds:		Appropriations.....	63,000
Special Fund.....	\$3,000	Surplus:	
Stores Fund.....	<u>5,000</u>	Unappropriated Surplus.....	\$2,000
Estimated Revenues.....	28,000	Surplus Receipts.....	<u>2,000</u>
Total.....	\$ 86,000	Total.....	\$ 86,000
SPECIAL FUND:		SPECIAL FUND:	
Cash.....	\$ 16,000	Vouchers Payable.....	\$ 2,000
Taxes Receivable.....	\$3,000	Due to General Fund.....	3,000
Less Reserve for Loss.....	<u>1,000</u>	Reserve for Encumbrances.....	2,000
Estimated Revenues.....	<u>6,000</u>	Appropriations.....	16,000
Total.....	24,000	Unappropriated Surplus.....	<u>1,000</u>
STORES FUND:		Total.....	24,000
Cash.....	\$ 8,000	STORES FUND:	
Stores.....		Vouchers Payable.....	\$ 4,000
Inventory.....	\$1,000	Reserve for Encumbrances.....	2,000
Orders.....	<u>2,000</u>	Due to General Fund.....	<u>5,000</u>
Total.....	11,000	Total.....	11,000
BOND FUND:		BOND FUND:	
Cash.....	\$ 38,000	Vouchers Payable.....	\$ 5,000
Bonds Authorized and Unissued.....	<u>25,000</u>	Reserve for Encumbrances.....	45,000
Total.....	63,000	Appropriations.....	9,000
		Unappropriated Balance.....	<u>4,000</u>
		Total.....	63,000

SINKING FUND:			
Cash.....	\$ 7,000		
Taxes Receivable.....	\$4,000		
Less Reserve for Loss.....	<u>1,000</u>		
Investments.....	3,000		
Requirements.....	1,000		
Total.....		14,000	14,000
ASSESSMENT FUND:			
Cash.....	\$ 38,000		
Bonds Authorized and Unissued.....	10,000		
Reimbursable Expenditures.....	3,000		
Available Authorisation.....	<u>47,000</u>		
Total.....		98,000	98,000
TRUST FUND:			
Cash.....	\$ 6,000		
Investments.....	<u>45,000</u>		
Total.....		51,000	51,000
PROPERTY:			
Property.....	\$996,000		
Improvements in Progress.....	<u>100,000</u>		
Total.....		1,096,000	1,096,000
Grand Total.....		\$1,443,000	\$1,443,000
SINKING FUND:			
Reserve for Retirement of Bonds.....	\$ 10,000		
Reserve for Bond Interest.....	3,000		
Income.....	<u>1,000</u>		
Total.....		14,000	14,000
ASSESSMENT FUND:			
Vouchers Payable.....	\$ 2,000		
Bonds Payable.....	50,000		
Reserve for Encumbrances.....	45,000		
Unencumbered Balance.....	<u>1,000</u>		
Total.....		98,000	98,000
TRUST FUND:			
Vouchers Payable.....	\$.....		
Trust Fund Balances:			
Permanent.....	50,000		
Expendable.....	<u>1,000</u>		
Total.....		51,000	51,000
PROPERTY:			
Bonds Payable.....	\$100,000		
Surplus Invested in Fixed Assets.....	<u>996,000</u>		
Total.....		1,096,000	1,096,000
Grand Total.....		\$1,443,000	\$1,443,000

Consolidated Fund Balance Sheet
(At the End of the Fiscal Year—After Closing)

	<u>General Fund</u>	<u>Special Fund</u>	<u>Stores Fund</u>	<u>Bond Fund</u>	<u>Sink- ing Fund</u>	<u>Assess- ment Fund</u>	<u>Trust Fund</u>	<u>Property</u>	<u>Total</u>
Assets									
Cash.....	\$14,000	\$7,000	\$ 9,000		\$ 4,000	\$14,000	\$ 6,000		\$ 54,000
Taxes Receivable—Less Reserve.....	5,000	2,000			3,000				10,000
Assessments Receivable.....						25,000			25,000
Due from Other Funds.....	8,000								8,000
Stores on Hand and Ordered.....			10,000						10,000
Investments.....					3,000		45,000		48,000
Public Benefit.....						5,000			5,000
Interest.....						2,000			2,000
Property.....								\$1,101,000	1,101,000
	<u>\$27,000</u>	<u>\$9,000</u>	<u>\$19,000</u>		<u>\$10,000</u>	<u>\$46,000</u>	<u>\$51,000</u>	<u>\$1,101,000</u>	<u>\$1,263,000</u>
Liabilities and Surplus									
Vouchers Payable.....	\$ 8,000	\$4,000	\$12,000						\$ 24,000
Tax Anticipation Warrants Payable.....	10,000								10,000
Reserve for Encumbrances.....	2,000	1,000	2,000						5,000
Due to Other Funds.....		3,000	5,000						8,000
Reserve for Retirement of Bonds.....									5,000
Reserve for Bond Interest.....					\$ 5,000				5,000
Bonds Payable.....					3,000				3,000
Surplus:						\$45,000		\$ 95,000	140,000
Unappropriated.....	7,000	1,000			2,000	1,000			11,000
Permanent Trust Fund Balance.....							\$50,000		50,000
Expendable Trust Fund Balance.....							1,000		1,000
Surplus Invested in Fixed Assets.....								1,006,000	1,006,000
	<u>\$27,000</u>	<u>\$9,000</u>	<u>\$19,000</u>		<u>\$10,000</u>	<u>\$46,000</u>	<u>\$51,000</u>	<u>\$1,101,000</u>	<u>\$1,263,000</u>

(Closed at the end of the year)

Deficit, credit Surplus. The bonds should be shown as a liability of the revenue fund, since they are payable from revenues to be raised by the fund. The condition should be shown in the balance sheet somewhat as follows:

Cash.....	\$20,000	Vouchers Payable..	\$35,000
Taxes Receivable	50,000	Appropriations....	40,000
Estimated Revenues.....	10,000	Unappropriated	
		Surplus.....	5,000
Subtotal.....	\$80,000	Subtotal.....	\$80,000
Funded Deficit...	15,000	Revenue Bonds....	15,000
	\$95,000		\$95,000

Revenues and receipts; expenditures and disbursements.

Revenues may differ from cash receipts, because revenues may have accrued and been credited to revenue accounts, although they have not been collected. Expenditures may differ from disbursements, because an expenditure is made as soon as a liability is incurred.

For these reasons it is desirable to prepare, for each fund and for all of the funds combined, both a statement of revenues and expenditures and a statement of receipts and disbursements. In these statements, the revenues and cash receipts should be classified by sources (taxes, licenses, and so forth); the expenditures and disbursements should be classified by departments (general administration, police department, and so forth), and, for each department, by objects (salaries, supplies, and so forth).

The statement of receipts and disbursements is made from the cash records. Data for the statement of revenues and expenditures are obtained as follows: revenues—from the subsidiary ledger revenue accounts; expenditures—from the accounts in the subsidiary expenditure analysis ledger supporting the subsidiary appropriations ledger. (See page 527.)

The dual account system.—All of the foregoing discussion and illustrations are applicable to the simplified system of accounting which is recommended in preference to the somewhat older, and more involved, dual account system. Under the dual account system, two separate groups of accounts are kept with each fund; one group is known as the budget, or fund, accounts; and the other, the proprietary accounts.

The operation of the dual account system is shown by the summary of accounts on page 554. The additional

PROPRIETARY ACCOUNTS

BUDGET, OR FUND, ACCOUNTS

	Estimated Revenues	Available Balance	Unapplied Cash	Encumbrances	Reserve for Encumbrances	Appropriations	Unappropriated Estimated Surplus		Cash	Taxes Receivable	Vouchers Payable	Expense	Revenue
(1) Estimated revenues—per budget.....	50					49*	50*			(No entries)			40*
(2) Appropriations—per budget.....		40					49*		25	40			
(3) Tax levy.....		25*	25						7	25*			7*
(4) Taxes collected.....			7	6	6*					(No entries)			
(5) Miscellaneous revenue collected.....										(No entries)			
(6) Orders placed.....										(No entries)			
(7) Vouchers certified:										(No entries)			
(a) Encumbrances reversed.....			4*	4*	4	4				(No entries)			4
(b) Vouchers recorded.....			(No entries)						3*	—	3		—
(8) Warrants issued.....										(No entries)			
Balances:										(No entries)			
Of budget accounts.....	3	15	28	2	2*	45*	1*		29	15	1*		4 47*
Of proprietary accounts.....	—	—	—	—	—	—	—		—	—	—		—

accounts required, and the entries therein, are shown in italics.

When this system of accounting is used, two balance sheets are prepared, as illustrated below:

General Fund Balance Sheets

(Date)

BUDGET ACCOUNTS		
Unapplied Cash.....		\$28,000.00
Available Balance.....		15,000.00
Estimated Revenues.....		3,000.00
		<u>\$46,000.00</u>
Reserve for Encumbrances..		\$ 2,000.00
Appropriations.....		43,000.00
Unappropriated Estimated Surplus.....		1,000.00
		<u>\$46,000.00</u>
PROPRIETARY ACCOUNTS		
Cash.....		\$29,000.00
Taxes Receivable.....		15,000.00
		<u>\$44,000.00</u>
Vouchers Payable.....		\$ 1,000.00
Surplus:		
Revenues.....	\$47,000.00	
Expenses.....	<u>4,000.00</u>	43,000.00
		<u>\$44,000.00</u>

The single balance sheet that would be prepared under the simplified system, appears below:

General Fund Balance Sheet

(Date)

Cash.....		\$29,000.00
Taxes Receivable.....		15,000.00
Estimated Revenues.....		3,000.00
		<u>\$47,000.00</u>
Vouchers Payable.....		\$ 1,000.00
Reserve for Encumbrances.....		2,000.00
Appropriations.....		43,000.00
Unappropriated Estimated Surplus.....		1,000.00
		<u>\$47,000.00</u>

CHAPTER 59

BANK ACCOUNTING

General ledger accounts.—The following trial balance shows the account balances of the general ledger of a commercial bank. It should be understood that many of the accounts are controls, which are supported by subsidiary ledgers or other records.

THE X NATIONAL BANK

Trial Balance

Cash on Hand.....	\$	2,363,100	
Federal Reserve Bank—Reserve Account		78,021,000	
Federal Reserve Bank—Transit Account.		4,833,000	
Due from Banks—Domestic.....		35,173,800	
Transit Account—Domestic.....		2,031,900	
Due from Banks—Foreign..		552,500	
Transit Account—Foreign...		35,100	
Exchange from Clearings.....		3,735,000	
Coupons and Bonds in Transit.		35,700	
Cash Items.....		19,500	
Sundry Holdovers.....		8,600	
Bills of Exchange.....		397,200	
U. S. Government Securities.....		70,812,000	
Other Securities.....		12,597,600	
Stock in Federal Reserve Bank.		600,000	
5% Redemption Fund for Note Circulation.....		100,000	
Call Loans.....		2,800,000	
Brokers' Loans.....		3,597,300	
Federal Reserve Funds Sold.....		150,000	
Bankers' Acceptances.....		450,500	
Commercial Paper.....		3,337,800	
Banks' and Bankers' Loans.....		2,840,000	
Commercial Loans.....		49,021,500	
Advances on Foreign Bills.....		145,000	
Other Loans and Advances.....		856,100	
Customers' Liability on Acceptances Executed..		240,900	
Acceptances Executed.....	\$		240,900
Funds in Anticipation of Maturing Acceptances.			27,300
Prepayments on Acceptances.....			30,000
Acceptances of this Bank.....		40,500	
Customers' Liability on Letters of Credit.....		418,200	
Letters of Credit Issued Under Guarantee.....			418,200
Payments Under Letters of Credit.....		12,000	
Letters of Credit and Travelers' Checks Sold for			
Cash.....			26,600

Overdrafts	13,200	
Accrued Interest Receivable	414,900	
Bank Building	1,300,000	
Furniture and Fixtures	358,400	
Other Resources	94,700	
Prepaid Expenses	157,800	
Capital Stock		20,000,000
Surplus		3,000,000
Undivided Profits		950,600
Contingent Reserve		159,300
Bond Reserve		182,100
Taxes Reserved and Unpaid		408,000
Unearned Discount		171,900
Note Circulation		2,000,000
Individual Deposits—Demand	134,803,600	
Special Deposits		295,000
Garnishee Accounts		6,400
Trust Department Deposits	24,104,000	
Bank Deposits—Domestic	38,200,000	
Bank Deposits—Foreign	2,883,000	
Cashier's Checks	3,579,000	
Certified Checks	2,101,200	
Expense Checks		29,900
Clearing House Return Checks		2,400
Public Funds	13,853,000	
Savings Deposits	28,647,000	
Certificates of Deposit		210,100
Interest and Discount		2,735,300
Exchange		29,000
Foreign Exchange		3,600
Trust Department Earnings		188,600
Rents Received		45,000
Other Earnings		242,100
Interest Paid or Accrued	700,600	
Expense	1,307,700	
	<u>\$279,573,100</u>	<u>\$279,573,100</u>

Nature of the accounts.—The nature and operation of the accounts shown in the foregoing trial balance are explained in the following comments:

Cash on Hand—\$2,363,100.00.

Currency and coins on hand are the only items included as cash in the statements and the accounts of a bank. Checks, money orders, and deposits in banks are segregated in the accounts and the statements. As cash on hand is a non-productive asset, a bank will ordinarily have on hand as little cash as possible; the amount will depend partly on the normal requirements and partly on the bank's accessibility to the Federal Reserve Bank.

Federal Reserve Bank—Reserve Account—\$78,021,000.00.

Federal Reserve Bank—Transit Account— 4,833,000.00.

All member banks are required to keep on deposit with the Federal Reserve Bank a certain percentage of their deposits; the percentages are determined by the nature of the customers' deposits and the bank's location, as follows:

Time deposits:

All member banks are required to maintain a 3% reserve.

Demand deposits:

Banks in central reserve cities (Chicago and New York) are required to maintain a 13% reserve.

Banks in the other sixty-four reserve cities are required to maintain a 10% reserve.

All other member banks must maintain a 7% reserve.

Items deposited with, or cleared through, the Federal Reserve Bank are ordinarily recorded in the Transit account until the credits are reported by the Reserve Bank, when they are transferred from the Transit account to the Reserve account. The proceeds of paper rediscounted with the Reserve Bank are credited directly to the Reserve account.

Due from Banks—Domestic—\$35,173,800.00.

Transit Account—Domestic— 2,031,900.00.

Banks normally maintain deposits with the correspondent banks through which their out-of-town checks, drafts, and collection items are cleared; therefore, a daily settlement for items cleared is not necessary. Such items are charged to the Transit account until the credits are reported by the correspondent bank, when they are transferred to the Due from Banks account.

Due from Banks—Foreign—\$552,500.00.

Transit Account—Foreign— 35,100.00.

These two accounts are operated in the same manner as the corresponding domestic accounts. They are kept in both foreign and domestic currencies, and the exchange gains or losses are determined in the manner described in Chapter 52.

Exchange from Clearings—\$3,735,000.00.

The balance of this account represents checks and other cash items on other banks in the same city, that are in process of

collection through the local clearing house or direct from the banks.

Coupons and Bonds in Transit—\$35,700.00.

Coupons and matured bonds presented to the bank by customers for collection are charged to, and carried in, this account until collected; after the coupons and bonds are collected, this account is credited, and Due from Banks or some other asset account is debited.

Cash Items —\$19,500.00.

Sundry Holdovers— 8,600.00.

These accounts are charged with collection and clearing items received too late to be put through the afternoon clearings. Items received by the tellers after the close of banking hours and held overnight in their cages are charged to Cash Items; items which have passed through the clearing department are charged to Sundry Holdovers.

Bills of Exchange—\$397,200.00.

This account is charged with notes and drafts received from customers for collection.

U. S. Government Securities—\$70,812,000.00.

Other Securities — 12,597,600.00.

These two accounts are charged with securities acquired.

Stock in Federal Reserve Bank—\$600,000.00.

All banks that are members of the Federal Reserve System are required to subscribe for Federal Reserve Bank stock in an amount equal to 6% of their capital stock and paid-in surplus; only one half of these subscriptions has been called. Stockholders are entitled to 6% cumulative dividends on their paid-up stock.

5% Redemption Fund for Note Circulation—\$100,000.00.

National banks with outstanding bank notes are required to maintain with the Treasurer of the United States a 5% redemption fund, and a deposit of Government bonds equal to 100% of the note circulation. Only the 5% fund is carried in this account; the deposited Government bonds are carried in the U. S. Government Securities account.

Call Loans —\$2,800,000.00.

Brokers' Loans— 3,597,300.00.

Both of these accounts are charged with loans to brokers, secured by readily marketable collateral and payable on demand—usually with twenty-four hours' notice. The distinction between the two accounts lies principally in the manner in which the loans are made: Brokers' loans are made by direct negotiation with the brokers; call loans are normally made in the New York call money market through the bank's New York correspondent. The interest rate on call loans varies with the call-loan rate in the stock exchange.

Federal Reserve Funds Sold—\$150,000.00.

This account is charged when portions of the deposits in the Federal Reserve Bank are advanced to correspondent banks.

Bankers' Acceptances—\$450,500.00.

This account is charged with the cost of bankers' acceptances purchased in the open market. These drafts usually arise through export and import transactions.

Commercial Paper—\$3,337,800.00.

This account shows the cost of short-term notes acquired from commercial paper brokers.

Banks' and Bankers' Loans—\$2,840,000.00.

The debit balance in this account shows the amount of loans made directly to other banks and bankers.

Commercial Loans—\$49,021,500.00.

This account is charged with the amount of direct loans made to customers on their secured or unsecured notes, and of indirect loans made to them by the discounting of notes or acceptances held by them.

Advances on Foreign Bills—\$145,000.00.

This account is charged with payments made to customers on foreign drafts discounted. Because of the greater risk involved in foreign drafts than in domestic drafts, the longer and less definite collection period, the exchange restrictions, and the uncertainty as to the charges which will be made by

the bank's correspondents, banks frequently advance only a portion, usually about 80%, of the discounted value of the drafts, and make a final settlement with the customer after receipt of the collection advice.

Other Loans and Advances—\$856,100.00.

This account is charged with loans, such as those made on real estate, which do not belong in any of the foregoing classifications.

Customers' Liability on Acceptances Executed—\$240,900.00 (debit).

Acceptances Executed—\$240,900.00 (credit).

Funds in Anticipation of Maturing Acceptances—\$27,300.00 (credit).

Prepayments on Acceptances—\$30,000.00 (credit).

Acceptances of this Bank—\$40,500.00 (debit).

In the simple acceptance transaction, the bank makes no actual advance of funds; by the act of acceptance, it merely promises to pay the draft at its maturity. The bank's customer, by a corollary agreement, promises to turn over to the bank the necessary funds before the maturity date, or authorizes the bank to charge paid acceptances to his account.

The bank's liability on the acceptance, although a direct liability, is thus offset by the customer's liability to the bank. The following entry is made by the bank at the time of acceptance:

Customers' Liability on Acceptances Executed	xx,xxx.xx
Acceptances Executed.....	xx,xxx.xx

These two accounts remain on the books until the maturity of the acceptance, when they are reversed.

If the customer pays in the entire amount of the acceptance before its maturity, such payment is credited to the Funds in Anticipation of Maturing Acceptances account. Partial payments by customers in advance of maturity are credited to the Prepayments on Acceptances account. Some banks with a small acceptance business do not keep the two latter accounts, but merely credit customers' advance payments to the Customers' Liability on Acceptances Executed account.

When the acceptance has matured, it will be presented to the bank for payment; two entries will be required:

(1) To reverse the accounts set up at the time of acceptance:

Acceptances Executed.....	xx,xxx.xx
Customers' Liability on Acceptances Executed....	xx,xxx.xx

(2) To record the payment; this entry will vary somewhat according to the circumstances:

(a) If the customer has paid in the entire amount of the acceptance:

Funds in Anticipation of Maturing	
Acceptances	xx,xxx.xx
Due to Banks (bank presenting acceptance).....	xx,xxx.xx

(b) If the customer has made a partial payment in advance:

Prepayments on Acceptances (for amount of payment).....	x,xxx.xx
Customer's Deposit Account (for balance)	x,xxx.xx
Due to Banks.....	xx,xxx.xx

(c) If the customer has made no payment in advance:

Customer's Deposit Account.....	xx,xxx.xx
Due to Banks.....	xx,xxx.xx

A bank may purchase its own acceptances in the open market before their maturity, just as it may purchase the acceptances of other banks; such purchases will be recorded in the Acceptances of This Bank account, which appears in the bank's balance sheet under the caption of Loans and Discounts. Purchased acceptances are eliminated from Customers' Liability on Acceptances Executed, and from Acceptances Executed, on the asset and liability sides of the balance sheet, respectively, as shown below. (These eliminations are made to prevent a duplication of the asset, and to remove the liability now non-existent.)

Resources

Loans and Discounts:			
Acceptances of This Bank.....		\$ 40,500.00	
Customers' Liability on Acceptances Outstanding:			
Customers' Liability on Acceptances Executed..	\$240,900.00		
Less:			
Funds in Anticipation of Maturing			
Acceptances.....	\$27,300.00		
Prepayments on Acceptances... ..	30,000.00		
Acceptances Acquired.....	40,500.00	97,800.00	143,100.00

Liabilities

Acceptances Outstanding:		
Acceptances Executed.....	\$240,900.00	
Less Acceptances Acquired.....	40,500.00	\$200,400.00

The entries to be made at the maturity of an acceptance purchased and carried in the Acceptances of this Bank account, would be the same as those, already described, to be made at the time of the payment of an acceptance, except that the bank would credit Acceptances of this Bank instead of Due to Banks, in entry (2).

- Customers' Liability on Letters of Credit—\$418,200.00 (debit).*
- Letters of Credit Issued Under Guarantee—\$418,200.00 (credit).*
- Payments Under Letters of Credit—\$12,000.00 (debit).*
- Letters of Credit and Travelers' Checks Sold for Cash—\$26,600.00 (credit).*

Commercial letters of credit are documents stating that the issuing bank will honor drafts under certain conditions and within certain limits. They are usually issued with the understanding that the customer's account will be charged, not with the amount of the letter of credit issued, but with the amounts of the drafts drawn against the letter and paid by the bank.

Typical entries are shown below:

At the time the letter is issued:

Customers' Liability on Letters of Credit	xx,xxx.xx
Letters of Credit Issued Under Guarantee	xx,xxx.xx

(These two accounts represent a contingent asset and a contingent liability, respectively, and may be reflected in the bank's balance sheet by a footnote only.)

When sight drafts drawn against the letter of credit are paid by the bank, the entries are:

Payments Under Letters of Credit (or Customer's Deposit Account)	x,xxx.xx
Due from Banks (Domestic or Foreign)	x,xxx.xx

The account Payments Under Letters of Credit is charged when, by agreement, the customer is to take up all of the drafts (plus interest) at the exhaustion of the credit, or at a specified future date, rather than at the date of payment by the bank. Otherwise the customer's deposit account is charged.

Letters of Credit Issued Under Guarantee	x,xxx.xx
Customers' Liability on Letters of Credit . . .	x,xxx.xx

When time drafts drawn against a letter of credit are accepted by the bank, the following entries are made:

Letters of Credit Issued Under Guarantee.....	x,xxx.xx	
Customers' Liability on Letters of Credit...		x,xxx.xx
Customers' Liability on Acceptances Executed..	x,xxx.xx	
Acceptances Executed.....		x,xxx.xx

The payment of the acceptances is recorded in the manner discussed in the preceding section, dealing with acceptances. When letters of credit or travelers' checks are issued for cash, the bank's entry is:

Cash (or Due from Banks).....	x,xxx.xx	
Letters of Credit and Travelers' Checks Sold for Cash.....		x,xxx.xx

Subsequent payments made by the bank against such letters are charged to the liability account.

Overdrafts—\$13,200.00.

When customers' checks are honored in amounts in excess of their credit balances, the resulting debit balances are controlled through this account.

Other Resources—\$94,700.00.

Any merchandise or other assets that the bank may have taken over in settlement of a loan, or any miscellaneous receivables, are usually classified as Other Resources.

Capital Stock—\$20,000,000.00.

Surplus—\$3,000,000.00.

Undivided Profits—\$950,600.00.

At the time of organization, banks very frequently issue their stock at a premium and thus create an immediate surplus. Profits are accumulated in the Undivided Profits account, and transferred to Surplus in round amounts.

Contingent Reserve—\$159,300.00.

Bond Reserve—\$182,100.00.

Taxes Reserved and Unpaid—\$408,000.00.

The Contingent Reserve is intended chiefly as a provision for losses on loans; it is sometimes created by monthly charges to operations, but more frequently by end-of-year provisions. The Bond Reserve is a provision for declines in the value of bonds and other investments. The tax reserve is a provision for the tax accrual.

Unearned Discount—\$171,900.00.

This is a deferred credit account, representing discounts deducted in making loans but not yet earned by the expiration of the loan period.

Note Circulation—\$2,000,000.00.

National banks are empowered to issue bank notes, provided they maintain the redemption fund and Government bond deposits previously mentioned. The bank's note issue is limited to the amount of its capital stock, and an annual tax of one half of one per cent must be paid for the circulation privilege.

Individual Deposits—Demand—\$134,803,600.00.

Special Deposits—\$295,000.00.

Garnishee Accounts—\$6,400.00.

Trust Department Deposits—\$24,104,000.00.

Bank Deposits—Domestic —\$33,200,000.00.

Bank Deposits—Foreign —\$ 2,883,000.00.

All of these credit balances reflect demand liabilities. Special Deposits include such items as deposits in escrow, balances of deceased persons, and deposits under court jurisdiction. Deposits that have been garnisheed by a creditor are not available to the depositor and are controlled by a special account. Trust Department Deposits represent uninvested funds held by the trust department for various trusts. The nature of the other deposit accounts is obvious.

Cashier's Checks—\$3,579,000.00.

Certified Checks —\$2,101,200.00.

Expense Checks —\$29,900.00.

Clearing House Return Checks—\$2,400.00.

Cashier's checks are the bank's own checks issued to its customers as a convenience. Certified checks are depositors' checks certified by the bank, and consequently segregated from the depositors' accounts. Expense checks are the bank's own checks issued in payment for expenses, and carried as a liability until presented for payment. Clearing house return checks are the bank's own checks, issued to other banks to take up clearing house return items.

Public Funds—\$13,853,000.00.

These accounts represent municipal, state, and Federal deposits.

Banks are frequently required to deposit Government bonds as collateral for such accounts.

Savings Deposits—\$28,647,000.00.

These deposits bear interest and are not subject to check. Under ordinary conditions, banks pay such deposits on demand, but the deposit agreement permits the bank to require a thirty-day or a sixty-day notice.

Certificates of Deposit—\$210,100.00.

These accounts represent interest-bearing time deposits.

Interest and Discount—\$2,735,300.00.

Exchange—\$29,000.00.

Foreign Exchange—\$3,600.00.

Trust Department Earnings—\$188,600.00.

Rents Received—\$45,000.00.

Other Earnings—\$242,100.00.

Interest Paid or Accrued—\$700,600.00.

Expense—\$1,307,700.00.

The nature of each of these income and expense accounts is apparent from its title.

Statements.—The following statements illustrate how the account balances shown by the trial balance are assembled in the income statement and in the statement of condition, or balance sheet. Two statements of condition are presented: one showing the assets and liabilities in detail, and another which has been condensed by grouping related items.

THE X NATIONAL BANK

Statement of Net Earnings

Year Ended _____

Earnings:	
Interest and Discount.....	\$2,735,300.00
Exchange.....	29,000.00
Foreign Exchange.....	3,600.00
Trust Department Earnings..	188,600.00
Rents Received.....	45,000.00
Other Earnings.....	<u>242,100.00</u>
Total Earnings.....	\$3,243,600.00
Expenses:	
Interest Paid or Accrued....	\$ 700,600.00
Operating Expenses.....	<u>1,307,700.00</u>
Total Expenses.....	<u>2,008,300.00</u>
Net Earnings.....	<u>\$1,235,300.00</u>

THE X NATIONAL BANK

Detailed Statement of Condition

(Date)

Resources		Liabilities	
Cash and Due from Banks:			
Cash on Hand.....	\$ 2,363,100	Capital, Surplus, and Undivided Profits:	
Federal Reserve Bank—Reserve Account	78,021,000	Capital Stock.....	\$ 20,000,000
Federal Reserve Bank—Transit Account	4,833,000	Surplus.....	3,000,000
Due from Sundry Banks—Domestic.....	35,173,800	Undivided Profits.....	2,185,900
Transit Account—Domestic.....	2,031,900	Reserves:	
Exchange from Clearings.....	3,736,000	Contingent Reserve.....	\$ 159,300
Due from Sundry Banks—Foreign.....	552,500	Bond Reserve.....	182,100
Transit Account—Foreign.....	35,100	Taxes Reserved and Unpaid.....	408,000
Coupons and Bonds in Transit.....	35,700	Unearned Discount.....	171,900
Cash Items.....	19,500	Note Circulation.....	921,300
Sundry Holdovers.....	8,800	Deposits:	
Bills of Exchange.....	397,200	Demand:	
Investments:	\$127,206,400	Individual.....	\$134,803,600
U. S. Government Securities (Pledged, \$16,410,000).....	\$70,812,000	Special Deposits.....	295,000
State and Municipal Bonds and Other Securities.....	12,597,600	Garnishee Accounts.....	6,400
Stock in Federal Reserve Bank.....	600,000	Trust Department Deposits.....	24,104,000
5 % Redemption Fund for Note Circulation.....	100,000	Bank Deposits—Domestic.....	38,200,000
Loans and Discounts:	\$4,109,600	Bank Deposits—Foreign.....	2,883,000
Call Loans.....	\$ 2,800,000	Certified Checks.....	2,101,200
Brokers' Loans.....	3,597,800	Cashier's Checks.....	3,579,000
Federal Reserve Funds Sold.....	150,000	Expense Checks.....	29,900
Bankers' Acceptances.....	450,500	Clearing House Return Checks.....	2,400
Commercial Paper.....	3,337,800	Letters of Credit and Travelers' Checks Sold	
Banks' and Bankers' Loans.....	2,840,000	for Cash.....	26,600
Commercial Loans.....	49,021,800	Total.....	\$206,031,100
Acceptances of this Bank.....	40,500	Public Funds.....	13,853,000
Payments Under Letters of Credit.....	12,000	Total Demand Deposits.....	\$219,884,100
Advances on Foreign Bills.....	145,000		
Other Loans and Advances.....	856,100		
	\$3,250,700		

Accrued Interest Receivable.....	414,900	Time:	
Customers' Liability on Acceptances Executed.....	\$ 240,900	Certificates of Deposit.....	\$ 210,100
Less:		Savings Deposits.....	28,647,000
Funds in Anticipation of Maturing		Total Time Deposits.....	\$ 28,857,100
Acceptances.....	\$27,300	Acceptances Executed.....	\$ 240,900
Prepayments on Acceptances.....	30,000	Less Acceptances Acquired.....	40,500
Acceptances Acquired.....	40,500		200,400
Bank Building.....	97,800		
	143,100		
	1,300,000		
Other Resources:			
Furniture and Fixtures.....	\$ 358,400		
Other Resources.....	94,700		
Overdrafts.....	13,200		
Prepaid Expenses.....	157,800		
	624,100		
	<u>\$277,048,800</u>		

\$277,048,800

Note: Contingent Liability on Letters of Credit Issued Under Guarantee, \$418,200.00.

CHAPTER 60

STOCK BROKERAGE

Broker's services to his customers.—The principal services rendered by a stock broker to his customers are the following:

- (1) Acting as their agents in the purchase and sale of securities. The broker is better able to make these purchases and sales for his customers than they are to make them for themselves, because the broker, through his stock exchange memberships and his contacts with other brokers, in the cities in which he maintains offices and elsewhere, has extensive information regarding the demand for and the supply of securities in which his customers desire to trade. Since he possesses this information, he is in a position to buy and sell a security at the most advantageous price obtainable in various markets.

The broker's service as agent for his customer also includes the guaranteeing of the accounts arising from sales; in other words, the broker acts as a *del credere* agent.

- (2) Providing information with respect to the financial status, earnings, and management of the companies whose securities are purchased and sold by his customers, and also information concerning the changes in the price of these securities.
- (3) Assisting his customers in the financing of their purchases. The customer usually deposits with the broker a portion of the purchase price, and the broker advances the remainder of the funds necessary to pay for the securities purchased.

This method of borrowing is a very convenient one for the customer. As no time limit is placed on

the loan, it is not necessary for the customer to arrange for renewals. Moreover, the amount of the loan is flexible; it is determined by the customer's changing requirements, and is increased and decreased to conform with them. Interest rates charged on the customers' accounts are changed when interest rates in the money market increase or decrease.

The funds loaned by the broker to his customers are obtained in part from the broker's capital investment, and in part from bank loans. To obtain these bank loans, the broker pledges his own securities or rehypothecates the securities left with him by his customers as collateral to their accounts.

- (4) Providing facilities for the safekeeping of the securities which his customers leave with him to collateralize their accounts and to facilitate the prompt delivery of securities which they may order him to sell. While the securities are in his possession, the broker renders his customers the further service of collecting the interest and dividends for them.

The stock exchange.—The stock exchange provides a convenient place where brokers with orders to sell may meet other brokers with orders to buy. In addition, if a clearing house is operated by the exchange, it greatly facilitates the settlement of transactions. Settlement procedures differ on the various exchanges, but the theory of the clearing house may be illustrated as follows:

On a certain day:

Broker Brown sold Broker Jones 2,000 shares of *B* Company stock for \$65,000.00.

Broker Jones sold Broker Smith 3,000 shares of *B* Company stock for \$97,800.00.

Broker Smith sold Broker Brown 2,000 shares of *B* Company stock for \$65,100.00.

Settlements for these transactions require payments of cash and deliveries of securities that may be facilitated by the clearing house, as explained in the summary on the opposite page.

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	Brown	Jones	Smith
Cash Receipts and Payments*			
If each broker were obliged to make a separate settlement with each other broker:			
Brown would collect from Jones.....	\$65,000	\$65,000*	
Jones would collect from Smith.....		97,800	\$97,800*
Smith would collect from Brown.....	65,100*		65,100

But settlement through the clearing house may be made on the basis of differences, thus:

Brown pays the clearing house.....	\$ 100*		
Smith pays the clearing house.....			\$32,700*
Jones collects from the clearing house...		\$32,800	

Security Receipts and Deliveries*

If each broker were obliged to make a separate settlement with each other broker, the number of shares delivered would be:

Brown would deliver to Jones.....	2,000*	2,000	
Jones would deliver to Smith.....		3,000*	3,000
Smith would deliver to Brown.....	2,000		2,000*

But settlement through the clearing house may be made on the basis of differences, thus:

Brown delivers and receives no shares...	—		
Jones delivers to the clearing house....		1,000*	
Smith receives from the clearing house..			1,000

Thus the three transactions, totaling 7,000 shares and \$227,900.00, are settled through the clearing house by the following net payments of cash and deliveries of securities:

	CASH		SHARES	
	Received	Paid	Received	Delivered
Brown.....		\$ 100.00	—	—
Jones.....	\$32,800.00			1,000
Smith.....		32,700.00	1,000	
	\$32,800.00	\$32,800.00	1,000	1,000

Broker's balance sheet: Principal items.—The following illustration shows the items of major importance that appear in a broker's balance sheet:

Balance Sheet—June 30, 1934

Assets	
Cash in Bank.....	\$ 471,000.00
Customers.....	12,250,000.00
	\$12,721,000.00
Liabilities and Net Worth	
Bank Loans.....	\$10,000,000.00
Capital.....	2,721,000.00
	\$12,721,000.00

Broker's security position.—Although the foregoing balance sheet may be a true picture of the broker's financial condition as shown by his general ledger, the following extremely important questions are not answered by it:

What is the market value of the securities left with the broker by his customers as collateral to the accounts totaling \$12,250,000.00? Unless these accounts are adequately secured, the broker may suffer losses in their realization.

How adequately are the bank loans secured by the rehypothecation of securities? Unless the bank loans are adequately secured, they may be called and the broker may be placed in financial difficulties.

What securities remain "in the box"; that is, in the broker's possession?

To give this important information, the foregoing balance sheet may be amplified as follows:

Balance Sheet—June 30, 1934

<u>Assets</u>	<u>Ledger Balances</u>	<u>Market Value of Securities</u>
Cash in Bank	\$ 471,000 00	
Customers	12,250,000.00	\$17,600,000 00
	<u>\$12,721,000 00</u>	<u>\$17,600,000.00</u>
Liabilities and Net Worth		
Bank Loans	\$10,000,000.00	\$15,800,000 00
Securities in the Box		1,800,000.00
Capital	2,721,000.00	
	<u>\$12,721,000 00</u>	<u>\$17,600,000.00</u>

Money and security records.—To provide the information required for a balance sheet in the form just illustrated, and also for the broker's control of his daily operations, his records must include:

- (1) A double entry system of accounts, similar to that employed by other lines of business, showing the assets, liabilities, income, expense, and capital of the business. The entries in these accounts are, of course, expressed in dollar amounts.
- (2) A double entry system of records showing both the

location and ownership of each security under the broker's control. Since market values of securities are continually changing, the security entries are made in terms of number of shares and face value of bonds; market values can be applied to these quantities whenever the determination of market values is required for any purpose.

To show why both of these classes of records are necessary, and how they are both kept on a double entry basis, let us assume that a broker purchases for a customer 200 shares of Z Company stock at \$20.00 per share. The dollar entries in the ledger accounts will be:

Customer A.....	4,025.00	
Cash.....		4,000.00
Commissions		25.00

The debit to the customer represents the amount which the broker is entitled to collect from him; the credit to Cash records the broker's disbursement in payment for the stock purchased; and the credit to Commissions shows the broker's earning on the transaction.

But the broker has received 200 shares of stock, and he has an obligation to deliver this stock to the customer when the customer pays his account. In other words, in addition to debiting the customer for the price of the stock, \$4,025.00, the broker must credit the customer with the 200 shares. Also, the broker's records should show the location of the stock. The facts concerning the securities are therefore recorded by the following debit and credit:

Box.....	200 shares	
Customer A.		200 shares

As used in connection with security entries, *debit* and *short* are synonymous, and *credit* and *long* are synonymous. The money debit and the security credit to the customer are posted to his account in the manner illustrated on the following page.

Attention is directed to the columns provided for the security entries. It should be noted that the Bought or Received column is a credit, or long, column, but that it appears at the left of the Sold or Delivered column, to

which the debit, or short, entries will be posted.

Customer A

Date	Bought or Received	Sold or Delivered	Description	Debit	Credit	Balance
Aug. 1	200		Z Company @ 20.00	4,025 00		4,025.00

The security entry debiting the box and crediting the customer is also posted to the long and short record, or position book, in which a separate sheet or card is devoted to each stock or bond. Various forms of position books are used, but the following illustration will serve our purpose. A debit, a credit, and a balance column are provided for each date, and the date is shown at the head of these columns. The debit and credit entries for the above-stated transaction, and the resulting long and short balances are shown below:

Z Company Stock

	1			2			3		
	Debit	Credit	Balance	Debit	Credit	Balance	Debit	Credit	Balance
<u>Short</u>									
Box.....	200		200						
<u>Long</u>									
Due to Customers:									
A.....		200	200						

The debit to Box shows the receipt of the securities, and the credit to the customer reflects the broker's obligation to account to the customer for the 200 shares. The position book thus shows both the location and the ownership of the stock.

Exchange settlements.—Under the rules of some stock exchanges, purchases and sales must be settled on the day following the transaction, except that Friday and Saturday transactions are settled on Monday. The New York Stock Exchange provides for settlement on the second day following the transaction. A delay is necessary because the volume of business done by a broker makes it impossible for him, within a single day, to make his purchases and sales on the floor of the exchange, to confirm the transactions with the

other brokers, to complete his records, to make any necessary arrangements for obtaining funds required for the payment of his purchases, and to assemble the securities needed to make deliveries. The exchange also requires time to make up its settlement records.

Because of the elapse of one or more days between the purchase and the payment of cash and receipt of the stock, it might seem that the entries for a purchase of stock should be made as follows.

On the day a purchase contract is made with another broker (say July 30):

Money entries:

Customer A.....	4,025.00	
Clearing House (For broker's liability)		4,000.00
Commissions.....		25.00

Security entries:

Clearing House (For stock receivable)...	200 shares	
Customer A.		200 shares

On the settlement day, when the contract is executed by the payment of cash to, and the receipt of stock from, the clearing house (say August 1):

Money entries:

Clearing House (For payment of liability)	4,000.00	
Cash.....		4,000.00

Security entries:

Box (For stock received).....	200 shares	
Clearing House.....		200 shares

However, if the broker purchases stock for his customer on July 30, but does not pay for and receive the stock until August 1, he cannot properly charge the customer until August 1. If the debit to the customer were made under date of July 30, the broker would charge the customer two days' interest to which he would not be entitled. Hence, it is customary to post-date the purchase and sales entries as of the settlement date, so that both the purchase and settlement are recorded as of the same date. The following entries,

all under date of August 1, would therefore be made for the foregoing transaction:

Money entries:

Customer A.....	4,025.00	
Clearing House		4,000.00
Commissions		25.00
For purchase of stock.		
Clearing House	4,000.00	
Cash.....		4,000.00
For settlement with the clearing house.		

Security entries:

Box.....	200 shares	
Customer A.....		200 shares

It will be noted that, in the money entries, Clearing House is debited and credited \$4,000.00. Since these entries exactly offset each other and are made as of the same date, many brokerage houses merely prove the equality of each day's debits and credits to the clearing house in the books of original entry, without posting them to a Clearing House account in the ledger. The posted entries are therefore as follows:

Money entries:

Customer A.....	4,025.00	
Commissions.....		25.00
Cash.....		4,000.00

Security entries:

Box.....	200 shares	
Customer A.....		200 shares

Principal transactions.—The following are the principal transactions affecting a broker's accounts with his customers:

- (1) Securities are purchased for the customer.
- (2) Securities are sold for the customer.
- (3) Cash is received from the customer.
- (4) Cash is paid to the customer.
- (5) Securities are received from the customer.
- (6) Securities are delivered to the customer.

These events may occur in various sequences. For

instance, a purchase may be made for a customer; on the settlement date, cash may be received from the customer and the securities delivered to him.

Or, a margin deposit may be received from the customer; securities may be purchased and, at a later date, sold. During the period between the purchase and the sale, the customer occupies a long position in the security.

Or, the sequence of purchase and sale may be reversed. If the customer believes that the price will decline, he may make a margin deposit and order his broker to sell; at a subsequent date, he will make a covering purchase. During the period between the sale and the purchase, the customer occupies a short position in the security.

Illustrative transactions.—We shall now consider a number of typical brokerage transactions, which differ in the sequence of the events enumerated in the preceding section. It does not appear desirable, within the limitations of a single chapter, to attempt to describe the books of original entry; we shall therefore merely indicate in a summary form the accounts to be debited and credited. A few of the ledger accounts will also be illustrated, to show how money and security entries are made therein. Throughout these illustrations, credit entries are indicated by asterisks.

Cash purchase.—One of the simplest series of brokerage transactions involves:

On one day:

The purchase of securities for a customer.

On the exchange settlement day:

The payment of cash to, and the receipt of stock from, the clearing house; and

The receipt of cash from, and the delivery of stock to, the customer.

Although these transactions would actually occur on two days, they would be recorded under date of the settlement day. To illustrate the method of accounting for this series of transactions, assume that:

- (a) A purchase of 200 shares of Z Company stock is made for John White, at \$20.00.

STOCK BROKERAGE

- (b) Payment is made to the clearing house.
- (c) The stock is received from the clearing house.
- (d) Collection is received from the customer.
- (e) The stock is delivered to the customer.

The following summary of money and security entries is not intended to illustrate the *form* of any book kept by a broker; it merely indicates the debits and credits in dollars and shares, required to record the foregoing transactions.

Trans- action	MONEY ENTRIES				SECURITY ENTRIES	
	John White	Clearing House	Com- missions	Cash	Box	John White
(a)	\$4,025 00	\$4,000.00*	\$25.00*			
(b)		4,000.00		\$4,000.00*		
(c)					200	200*
(d)	4,025.00*			4,025 00		
(e)					200*	200

* Credit.

The money and security debits and credits to the customer, John White, are posted as follows:

John White						
Date	Bought or Re- ceived	Sold or De- livered	Description	Debit	Credit	Balance
Aug. 1	200		Z Company at 20.00	4,025.00		4,025.00
Aug. 1		200	Z Company		4,025.00	—

The offsetting debit and credit to Clearing House are not posted. The Commissions and Cash accounts are not illustrated; they would contain only the money entries as stated.

The security entries are posted to the position book, thus:

Z Company Stock									
Short	1			Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
	Debit	Credit	Bal- ance						
Box.....	(c)200	(e)200	—						
Long									
Due to Customers:									
John White.....	(e)200	(c)200	—						

Margin purchase.—This is one of the most common brokerage transactions. Instead of settling immediately for the cost of the securities, the customer arranges in advance to have the broker carry the account on margin; in other words, the customer makes a margin deposit of cash and/or securities with the broker, and the broker carries the customer's account for the excess of the purchase price and the commission over the amount of the margin deposit. To illustrate, assume the following transactions:

- (f) James Black deposits with the broker \$4,500.00 as a margin.
- (g) The broker purchases 400 shares of Z Company stock at \$20.00.
- (h) The broker pays for the stock.
- (i) The stock is received by the broker and held as collateral to the customer's account.

The debits and credits, in dollars and shares, are summarized as follows:

Trans- action	MONEY ENTRIES				SECURITY ENTRIES	
	James Black	Clearing House	Com- missions	Cash	Box	James Black
(f)	\$4,500 00*			\$4,500 00		
(g)	8,050.00	\$8,000 00*	\$50.00*			
(h)		8,000.00		8,000.00*		
(i)					400	400*

* Credit.

The position book sheet for the Z Company stock appears as follows:

	1			2			Debit	Credit	Bal- ance
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance			
<u>Short</u>									
Box.....	(e)200	(e)200	—	(i)400		400			
<u>Long</u>									
Due from Customers:									
John White.....	(e)200	(e)200	—						
James Black.....				(i)400	400				

Subsequent sale.—In this transaction, James Black, who occupied a long position in Z Company stock as a result of the preceding transaction, disposed of part of his holdings.

The Federal tax on sales is paid by the broker, by the application of revenue stamps which the broker purchases for that purpose and carries in an asset account. Assume the following transactions:

- (j) The broker sells 100 shares of Z Company stock at \$22.00.
- (k) The broker collects the selling price of the stock through the clearing house.
- (l) The stock is delivered to the clearing house.

The debits and credits, in dollars and shares, are as follows:

Trans- action	MONEY ENTRIES					SECURITY ENTRIES	
	James Black	Clearing House	Com- mis- sions	Revenue Stamps	Cash	Box	James Black
(j)	\$2,178.50*	\$2,200.00	\$12 50*	\$9.00*			
(k)		2,200.00*			\$2,200.00		
(l)						100*	100

* Credit.

The customer's account, after these entries have been posted, appears as follows:

James Black

Date	Bought or Re- ceived	Sold or De- livered	Description	Debit	Credit	Balance
(f) Aug. 2			Cash margin		4,500 00	4,500.00 Cr.
(g) 2	400		Z Co. at 20.00	8,050.00		3,550.00 Dr.
(j) 3		100	Z Co. at 22.00		2,178 50	1,371 50 Dr.

The customer now has a debit money balance of \$1,371.50, and a long security balance of 300 shares. The position book sheet for the Z Company stock is continued as follows:

Z Company Stock

	1			2			3		
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
<u>Short</u>									
Box.....	(c)200	(e)200	—	(i)400		400		(l)100	300
<u>Long</u>									
Due to Customers:									
John White.....	(e)200	(c)200	—			—			—
James Black....				(i)400		400	(l)100		300

Short sale.—In transactions of this type, the customer orders his broker to sell securities which the customer does not own, and which he must therefore purchase at a later date, hoping to do so at a reduced price. The broker is expected to deliver immediately the stock thus sold short; and we shall assume, in this illustration, that the broker obtains the consent of James Black to use for this purpose some of Black's shares which the broker is holding as collateral. Assume the following transactions:

- (m) George Green deposits with the broker \$2,500.00 as collateral.
- (n) The broker sells 200 shares of Z Company stock at \$24.00.
- (o) The broker collects for the stock.
- (p) The stock is delivered to the purchasing broker through the clearing house.

The debits and credits, in money and securities, for these transactions are summarized below:

Transaction	MONEY ENTRIES					SECURITY ENTRIES	
	George Green	Clearing House	Com-mis-sions	Revenue Stamps	Cash	Box	George Green
(m)	\$2,500 00*				\$2,500.00		
(n)	4,757 00*	\$4,800 00	\$25.00*	\$18 00*			
(o)		4,800 00*			4,800 00		
(p)						200*	200

* Credit.

The customer's account is shown in the next illustration. The position book entries are shown below.

	2			3			4		
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
Short									
Box	(i)400		400		(l)100	300		(p)200	100
Due from Customers:									
George Green . . .							(p)200		200
									<u>300</u>
Long									
Due to Customers:									
John White									
James Black		(i)400	400	(l)100		300			<u>300</u>

Because of space limitations, it is necessary in the position book illustrations to drop one day's entries as each new day's entries are added.

Subsequent purchase.—George Green, who occupied a short position in the Z Company stock as a result of the preceding short sale, makes a partial covering purchase. Assume the following transactions:

- (q) The broker purchases 100 shares of Z Company stock at \$22.50.
- (r) The broker pays for the stock.
- (s) The broker receives the stock for Green's account.

The debits and credits, in money and securities, for these transactions are summarized below:

Trans- action	MONEY ENTRIES				SECURITY ENTRIES	
	George Green	Clearing House	Com- missions	Cash	Box	George Green
(q)	\$2,262.50	\$2,250.00*	\$12.50*			
(r)		2,250.00		\$2,250.00*		
(s)					100	100*

* Credit.

The position book is continued as follows:

Z Company Stock									
	3			4			5		
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
<u>Short</u>									
Box.....		(l)100	300		(p)200	100	(s)100		200
Due from Cus- tomers:									
George Green...				(p)200		200		(s)100	100
						300			300
<u>Long</u>									
Due to Customers:									
John White.....			—			—			—
James Black...	(l)100		300			300			300

The customer's account appears on the following page. This account shows that the customer has a \$4,994.50 credit money balance, and a short security balance of 100 shares.

George Green

Date	Bought or Received	Sold or Delivered	Description	Debit	Credit	Balance
(m) Aug. 4			Cash margin		2,500.00	2,500 00 Cr.
(n) 4		200	Z Co. @ 24.00		4,757.00	7,257.00 Cr.
(q) 5	100		Z Co. @ 22.50	2,262.50		4,994.50 Cr.

Sale with failure to deliver.—For various reasons a broker may be unable to make immediate delivery of stock sold. He may have none in the box; or the certificates in the box may not be such as to permit the delivery of the exact number of shares required; or the broker may be unable to obtain, from a customer occupying a long position in the stock, consent to use his shares to make the delivery.

Although exchange rules and brokers' practices regarding sales on which deliveries are not immediately made, vary somewhat in different cities, the following illustrations show the principal accounting requirements.

- (t) Fred Grey deposits with the broker \$3,500.00 as a margin.
- (u) The broker sells 300 shares of Z Company stock at \$23.00.
- (v) The broker finds that he is unable to make delivery of the stock, and he records the "failure" by debiting Failed to Deliver and crediting Clearing House, \$6,900.00, thus showing that the proceeds from the sale are not immediately collectible from the clearing house, but are collectible only when the broker is in a position to deliver the stock.

The debits and credits, in money and securities, for these transactions are summarized below:

Transaction	MONEY ENTRIES					SECURITY ENTRIES		
	Fred Grey	Clearing House	Com-missions	Revenue Stamps	Cash	Failed to Deliver	Failed to Deliver	Fred Grey
(t)	\$3,500.00*				\$3,500.00			
(u)	6,835.50*	\$6,900.00	\$37.50*	\$27.00*				
(v)		6,900.00*				\$6,900.00	300*	300

* Credit.

The \$6,900.00 debit money balance in the Failed to Deliver account represents the amount that the broker is entitled to receive from the purchasing broker when the stock is delivered. The credit, or long, security balance in the Failed to Deliver account reflects the broker's obligation to deliver the 300 shares.

The position book is continued as follows:

Z Company Stock

	4			5			6		
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
Short									
Box		(p)200	100	(s)100		200			200
Due from Customers:									
George Green	(p)200		200		(:)100	100			100
Fred Grey . . .							(v)300		300
			<u>300</u>			<u>300</u>			<u>600</u>
Long									
Due to Customers:									
John White . . .			—			—			—
James Black . .			300			300			300
Failed to Deliver.							(v)300		300
			<u>300</u>			<u>300</u>			<u>600</u>

When the broker is in a position to deliver the stock, the settlement may be made through the clearing house, but it is usually made directly with the other broker. The money entry for the collection of the sale price will be: Debit Cash and credit Failed to Deliver, \$6,900.00. The security entry for the delivery of the stock will be: Debit Failed to Deliver and credit Box, 300 shares.

Sale with delayed delivery.—The sale with failure to deliver, just illustrated, was recorded as it would be if the selling broker made no arrangements with the purchasing broker for a delayed delivery, but simply failed to deliver. Arrangements for a delayed delivery may be made in advance. To illustrate the slightly different accounting procedure, assume that, in the preceding illustration, the selling broker had arranged with the purchasing broker for a delay in the delivery of the 300 shares. Instead of entry (u) in the foregoing summary, the selling broker would have made the following entries:

Money entries:

Delayed Delivery	6,900.00	
Fred Grey		6,835.50
Commissions		37.50
Revenue Stamps		27.00

Security entries:

Fred Grey.....	300 shares	
Delayed Delivery.....		300 shares

Since the money charge was made directly to the Delayed Delivery account, instead of to the Clearing House account, entry (v) is not required.

When settlement is made, the selling broker will debit Cash and credit Delayed Delivery, \$6,900.00; he will also debit Delayed Delivery and credit Box, 300 shares.

Purchase with failure to receive.—To illustrate the accounting procedure of a broker who has purchased stock from another broker who fails to deliver, assume the following transactions:

- (w) The broker receives a margin deposit of \$4,500.00 from Henry Brown.
- (x) The broker purchases 400 shares of Z Company stock at \$20.00.
- (y) The selling broker fails to deliver.

The debit and credit entries, in money and securities, are summarized as follows:

Trans- action	MONEY ENTRIES				SECURITY ENTRIES		
	Henry Brown	Clearing House	Com- mis- sions	Cash	Failed to Receive	to Re- ceive	Henry Brown
(w)	\$4,500.00*			\$4,500.00			
(x)	8,050.00	\$8,000.00*	\$50.00*				
(y)		8,000.00			\$8,000.00*	400	400*

* Credit.

The \$8,000.00 credit balance in the Failed to Receive account shows the purchasing broker's obligation to pay for the stock when it is received; the debit, or short, security balance reflects his claim against the selling broker for the shares not yet received.

The subsequent settlement may be made through the clearing house, but it is usually made directly between the two brokers involved. In the latter case, the purchasing broker's entries are: Debit Failed to Receive and credit Cash, \$8,000.00; debit Box and credit Failed to Receive, 400 shares.

The position book prior to the settlement appears below.

Z Company Stock

	5			6			8		
	Debit	Credit	Balance	Debit	Credit	Balance	Debit	Credit	Balance
Short									
Box.....	(s)100		200			200			200
Due from Customers:									
George Green.		(s)100	100		100				100
Fred Grey....				(v)300	300				300
Failed to Receive.							(y)400		400
			300		600				1,000
Long									
Due to Customers:									
John White....			—		—				—
James Black.			300		300				300
Henry Brown							(y)400		400
Failed to Deliver.				(v)300	300				300
			300		600				1,000

Purchase with delayed receipt.—If, at the time of the purchase, the purchasing broker consents to a delayed receipt, the entries will differ somewhat from those made when the non-delivery is the result of a failure without previous agreement. To illustrate, the transactions in the preceding section, "Purchase with failure to receive," are referred to. In entry (x), the \$8,000.00 credit would be made to Delayed Receipt instead of to Clearing House; and entry (y) would then include only the security debit and credit.

Stock borrowed.—A broker who has no available stock with which to make delivery on a short sale may borrow the stock from some other broker. Or, assume that Broker A has sold stock to Broker B and has failed to deliver; in order to make delivery to his own customer, Broker B has a right to buy the stock elsewhere and to charge Broker A with the cost thereof. To avoid a possible loss that might result from this threatened "buy-in," Broker A may borrow the stock from Broker C and deliver it to Broker B. When Broker A borrows the stock, he gives Broker C his check for the market value thereof; he may also give Broker C a due bill for the stock, although practice in this respect varies. If the market price of the borrowed stock rises or falls, the

cash deposit with Broker C is increased or decreased to keep it "marked to the market." To illustrate, assume the following transactions:

- (z) William Rose deposits with the broker \$3,500.00 as a margin.
- (aa) The broker sells 300 shares of Z Company stock at \$23.00.
- (bb) The broker borrows the stock from Broker C.
- (cc) The selling price is received from, and the stock is delivered to, the clearing house.

The debit and credit entries are summarized as follows:

Trans- action	MONEY ENTRIES					SECURITY ENTRIES			
	William Rose	Clearing House	Com- mis- sions	Revenue Stamps	Cash	Stocks Bor- rowed	Stocks Bor- rowed	Box	Wil- liam Rose
(z)	\$3,500.00*				\$3,500 00				
(aa)	6,835.50*	\$6,900.00	\$37.50*	\$27.00*					
(bb)					6,900 00*	6,900.00	300*	300	
(cc)		6,900.00*			6,900 00			300*	300

* Credit.

These entries differ from preceding entries for sales only in so far as the debits and credits for the borrowed stock are concerned. The debit money balance in the Stocks Borrowed account represents the broker's right to receive \$6,900.00 from Broker C when the borrowed stock is returned to him. The credit, or long, security balance in the Stocks Borrowed account shows the broker's obligation to deliver 300 shares to Broker C in return for the stock borrowed.

The position book is continued as follows:

Z Company Stock

	6			8			9		
	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance	Debit	Credit	Bal- ance
(c) Short									
Box.....			200			200	(bb)300	(cc)300	200
Due from Customers:									
George Green.....			100			100			100
Fred Grey.....	(v)300		300			300			300
William Rose.....							(cc)300		300
Failed to Receive.....			—	(y)400		400			400
			600			1,000			1,300
Long									
Due to Customers:									
John White.....			—			—			—
James Black.....			300			300			300
Henry Brown.....				(y)400		400			400
Failed to Deliver.....	(v)300		300			300			300
Stocks Borrowed.....							(bb)300		300
			600			1,000			1,300

Stock loaned.—A broker who loans stock to another broker and receives a check for the stock thus loaned, will make entries as indicated below:

Transaction	MONEY ENTRIES		SECURITY ENTRIES	
	Cash	Stock Loaned	Box	Stock Loaned
(dd)	\$1,150.00	\$1,150.00*	50*	50

* Credit.

The credit money balance in the Stocks Loaned account shows the broker's liability to return the cash to the borrowing broker when the stock is returned. The debit, or short, security balance shows the broker's right to receive the 50 shares of stock.

The position book is continued as follows:

Z Company Stock

Short	8			9			10		
	Debit	Credit	Balance	Debit	Credit	Balance	Debit	Credit	Balance
Box			200	(bb)300	(cc)300	200		(dd)50	150
Due from Customers:									
George Green			100			100			100
Fred Grey			300			300			300
William Rose				(cc)300		300			300
Failed to Receive									
Stock Loaned	(y)400		400			400	(dd)50		400
									50
			<u>1,000</u>			<u>1,300</u>			<u>1,300</u>
Long									
Due to Customers:									
John White			—			—			—
James Black			300			300			300
Henry Brown		(y)400	400			400			400
Failed to Deliver			300			300			300
Stock Borrowed				(bb)300		300			300
			<u>1,000</u>			<u>1,300</u>			<u>1,300</u>

Transactions settled direct.—Some transactions are settled directly by the two brokers involved and do not pass through the exchange and the clearing house. This may occur if the security traded in is not listed on the exchange, or if, although listed, it is so inactive that offset settlements are not made by the exchange. In such instances, each broker debits and credits the other broker in accounts that are kept in the same way as customers' accounts.

For example, assume that Broker C buys for the account of a customer 100 shares of Blank Company stock from Broker D. The entries on the books of Broker C are summarized as follows:

Trans- action	MONEY ENTRIES				SECURITY ENTRIES		
	Customer	Broker <i>D</i>	Com- mission	Cash	Broker <i>D</i>	Box	Cus- tomer
Purchase	\$2,012 50	\$2,000 00*	\$12.50*		100		100*
Settlement		2,000 00		\$2,000.00*	100*	100	

* Credit.

The account with Broker *D* would appear as follows:

Date	Bought or Re- ceived	Sold or De- livered	Description	Debit	Credit	Balance
July 9		100	Blank Company @ 20.00		2,000.00	2,000 00
July 11	100		Blank Company	2,000.00		—

Bank loans.—In order to be able to carry their customers' accounts, brokers frequently borrow from banks. Bank loans are generally secured by the deposit, as collateral, of securities owned by the broker, or held by him as collateral to his customers' accounts. The money entries to record a bank loan are: Debit Cash and credit Bank Loans. The security entries are: Debit Pledged with Banks and credit Box. The shares thus pledged will appear as a short item in the position book.

Stock out for transfer.—When a broker sends stock to the issuing company's transfer agent for the issuance of new certificates, usually in the broker's name, entries are made in the position book, debiting Due from Transfer Office and crediting Box.

Dividends receivable.—To reflect the amounts of dividends receivable on stocks under the broker's control, the portions of such dividends that must be paid to other parties, and the portion that can be taken into income, entries are made for dividend amounts determined on the basis of the position shown by the position book on the date when the stock went ex-dividend. To illustrate, assume that the position book showed the following long and short items:

Short

- (a) Due from customers.
- (b) Due from brokers.

- (c) Stocks loaned.
- (d) Failed to receive.
- (e) Pledged with banks.
- (f) Due from transfer office.
- (g) Box.

Long

- (h) Due to customers.
- (i) Due to brokers.
- (j) Stocks borrowed.
- (k) Failed to deliver.
- (l) Stocks owned.

Theoretically, the broker should make the following entry:

Accounts Debited and Credited	For Dividends on Items
Various customers	(a)
Various brokers	(b), (c), (d)
Collectible Dividends	(e), (f), (g)
Various customers	(h)
Various brokers	(i), (j), (k)
Dividends (income account)	(l)

Actually, it may be impossible to determine the amounts to be credited to various customers and to various brokers. Under such conditions, the broker credits customers and brokers with the amounts to which he knows they are entitled, he credits the Dividends account with dividends on the stock which he himself owns, and he credits any unallocated remainder to the Unclaimed Dividends account. The Unclaimed Dividends account is therefore a suspense account representing a liability to parties who, temporarily, cannot be determined.

Margin records.—In addition to the accounts with customers, showing money and security entries as already illustrated, brokerage concerns must keep margin records, which show whether or not the customers' accounts are adequately margined. Postings to the margin records and to the customers' accounts are made from the same sources and with the same promptness. The margin records are of extreme importance, as they furnish the information required by the broker to prevent the losses that might arise from a decline in the market value of securities held as collateral

to the account of a customer occupying a long position, or the losses that might be occasioned by a rise in the market value of securities which a customer has sold short. The margin requirement for each stock or bond is separately determined on the basis of legal regulations.

There are several forms of margin records, but the following illustration shows how they may be maintained. Let us assume that a customer has made a margin deposit of \$5,000.00, and that he has purchased 400 shares of Y Company stock for \$8,800.00 and has been charged with the cost thereof plus \$50.00 commission. His ledger account therefore has a debit balance of \$3,850.00. Let us assume, also, that a net margin of \$2,800.00 is regarded as adequate for this particular stock; that is, no additional margin will be called for unless the customer's equity in the stock decreases below that amount. The margin card at the time of the purchase will appear as follows:

Name.....		Address.....		Telephone.....		
LONG	SHORT	SECURITY		PRICE	VALUE	REQUIRED
400		Y Company		22	\$8,800.00	\$2,800.00
<i>(Several lines are provided for listing other securities)</i>						
		Market value (total)			8,800.00	
		Balance (of ledger account)			3,850.00	
		Equity			4,950.00	

The amount shown on the Balance line is the debit balance of the customer's account. The card shows that the value of the stock is \$4,950.00 in excess of the customer's debit balance; in other words, the customer has a \$4,950.00 equity in the stock on the basis of its present market value. Since only \$2,800.00 is required, the account is adequately margined.

If the customer has purchased several securities, the total market value thereof and the total margin required would be shown on the total line; the balance of the customer's account would be deducted from the total market value; and the remainder, or total equity, would be compared with the total requirement.

Let us assume that the price of the Y Company stock

drops to \$18.00. The entries on the margin card were made in pencil so that they could be easily erased and new figures inserted. The margin card showing the changed margin status appears below:

Name.....		Address.....		Telephone.....		
LONG	SHORT	SECURITY		PRICE	VALUE	REQUIRED
400		Y Company		18	\$7,200 00	\$2,800.00
		Market value (total)			7,200.00	
		Balance			3,850 00	
		Equity			3,350 00	

The equity is still in excess of the \$2,800.00 requirement, but further declines in the market value of this security will have to be very closely watched. A decrease of \$1.50 per share would reduce the equity to \$2,750.00, which is less than the requirement.

Interest charges to customers.—Customers are charged with interest as a consequence of security purchase transactions, but not as a consequence of short sale transactions. To show the reason for this difference, let us assume the following transactions:

A customer makes a margin deposit of \$3,000.00, and purchases securities at a cost of \$5,525.00, including commission; his account therefore has a debit balance of \$2,525.00, representing the amount of funds advanced by the broker, plus the commission charge. The broker can therefore properly charge interest on \$2,525.00.

A customer makes a margin deposit of \$2,500.00, and orders his broker to make a short sale that involves a credit to his account in the net amount of \$4,657.00. His account therefore has a credit balance of \$7,157.00. Obviously, the broker cannot charge his customer any interest, because the broker's capital is not used. Although the broker may be obliged to borrow the stock for delivery and to deposit his own check with the broker who loans the stock, this disbursement is offset by the collection and retention of the proceeds from the sale.

Partners' trading accounts.—If purchase or sales orders are executed for individual members of the brokerage firm, the partners virtually become customers of the firm, and the ledger should show the resulting charges and credits to them in accounts that are kept in the same manner as the customers' accounts. The customers' accounts are kept in a subsidiary ledger under the control of a general ledger Customers account. Theoretically, it is undesirable to keep the partners' trading accounts in the subsidiary ledger, but, if machine bookkeeping is used, it may be desirable to do so from the standpoint of convenience. In any event, the partners' trading accounts should be set out as separate items in the periodical statements.

Trading Securities account.—If a brokerage firm buys securities for its own account, a Trading Securities account is charged with the cost thereof. When the securities are subsequently sold, entries may be made in either of two ways:

- (1) The Trading Securities account may be credited with the cost of the securities sold, and the profit or loss may be taken up immediately by a credit or debit to the Trading Profits account.
- (2) The Trading Securities account may be credited with the selling price of the securities sold; at intervals, the unsold securities will be inventoried, and the profit or loss thus ascertained. When the account is operated in this manner, it is similar to an old-fashioned Merchandise account.

This account is generally used to record only those transactions that involve the purchase and subsequent sale of securities; the firm's short sales, with subsequent purchases, are usually recorded in the account discussed below.

Short Sales account.—This account should be credited with the proceeds of short sales made by the firm for its own account, and should be charged with the cost of subsequent purchases. Any profits or losses should be reflected in the Trading Profits account.

Syndicate Securities account.—This account should be charged with the cost of securities purchased by the firm as a

member of a syndicate, credited with the proceeds of sales, and recharged with the cost of any securities repurchased from the public for the purpose of maintaining the market or for other reasons. Profits may be taken up periodically by inventorying the unsold securities, or the more conservative procedure may be followed of postponing the taking of profit until all of the securities are sold. Profits or losses should be reflected in the Syndicate Profits account, which may also be credited with any amount received from the syndicate manager as the broker's share of the direct syndicate profit.

If the broker is participating in numerous syndicates, the Syndicate Securities account in the general ledger should be operated as a controlling account, with subsidiary records reflecting the operations of each syndicate.

Summary of general ledger accounts.—The typical general ledger accounts of a brokerage firm are listed below. The operation of many of these accounts has been explained in the preceding pages of this chapter.

Asset Accounts

Cash:

Accounts with cash in banks and on hand are operated in the same manner as similar accounts of other businesses.

Stock Clearing Funds:

This account shows deposits made with stock exchanges to guarantee the clearing of transactions.

Revenue Stamps:

This account is charged with the cost of revenue stamps purchased, and is credited with stamps charged to customers to cover the tax on sales or used in connection with the firm's own trading operations.

Customers:

This account controls a subsidiary ledger containing accounts that may have balances of the following four classes:

- (1) Debit balances secured by collateral.
- (2) Credit balances resulting from short sales.
- (3) Free credit balances payable to customers.
- (4) Unsecured debit balances that may develop if a

broker does not obtain adequate collateral and does not sell the customer's securities before his margin is exhausted.

The periodical statements should show these four classes of balances, as disclosed by the trial balance of the subsidiary ledger, instead of the net balance of the controlling account.

Other Brokers:

These accounts will show amounts receivable from brokers as a result of such transactions as sales to them that are to be settled direct instead of through the clearing house.

Failed to Deliver:

The operation of this account was explained on page 585. Its debit balance represents the amount receivable for securities that the broker has failed to deliver.

Delayed Delivery:

This account is similar to the Failed to Deliver account. It is used when a delayed delivery was agreed upon at the time of the sale.

Stocks Borrowed:

The operation of this account was explained on page 588. It is charged with cash deposits made with other brokers to assure the return of securities borrowed from them. It may be operated on a controlling account basis.

Notes Receivable:

This account is charged and credited in the usual manner.

Collectible Dividends:

The nature of the charges to this account was indicated on page 592.

Partners' Trading Accounts:

These accounts were discussed on page 595. Debit balances should be deducted from the Capital accounts in the balance sheet.

Trading Securities:

This account was discussed on page 595.

Syndicate Securities:

This account was discussed on page 595.

Exchange Seat:

This account shows the cost of the broker's seat on the exchange.

Fixed Assets and Reserves:

Accounts with fixed assets, and the related depreciation reserves, are kept in the usual manner.

Deferred Charges:

Accounts with prepaid expenses are kept as in any other business.

Liability Accounts

Notes Payable:

These accounts show note liabilities, principally to banks.

Other Brokers:

These accounts show amounts payable to other brokers as a result of such transactions as purchases from them that are to be settled direct instead of through the clearing house.

Failed to Receive:

The operation of this account was explained on page 587. Its credit balance represents the broker's liability to pay for stocks that will subsequently be received on "failed" transactions.

Delayed Receipt:

This account is similar to the Failed to Receive account; it is used when a delay was agreed upon at the time of the purchase.

Stocks Loaned:

The operation of this account was explained on page 590. It is credited with the amounts of deposits received from other brokers to assure the return of securities loaned to them.

Unclaimed Dividends and Coupons:

The credits made to this account in connection with dividends were explained on page 592. Similar credits are made in connection with matured coupons on bonds. When proof of claim is submitted, payment is made and this account is debited.

Short Sales:

This account is credited with the proceeds from short sales made by the firm for its own account.

Partners' Short Sales:

These accounts are credited with the proceeds from short sales made for the partners' individual accounts.

Accrued Expenses:

Such accounts are operated as in any other business.

Partners' Capital:

These accounts are debited and credited as similar accounts are in any other partnership.

Clearing Accounts**Clearing House:**

The debits and credits to this account have been illustrated in the preceding pages. As the debits and credits to this account for each day's transactions should always be equal, brokers frequently omit the postings to the account.

The peculiarities of brokerage accounting arise principally in connection with the asset and liability accounts. The accounting for income and expense is extremely simple.

Income Accounts**Commissions:****Customers' Interest:**

These accounts are credited with commissions and interest charged to customers.

Trading Profits:**Syndicate Profits:**

These accounts show the profits or losses on the firm's own transactions recorded in the Trading Securities, Short Sales, and Syndicate Securities accounts.

Other Interest:**Dividends:**

These accounts may be subdivided as much as necessary to furnish the information desired for the operating statements or required for the income tax return.

Expense Accounts**Interest Expense:****Salaries:****Rent:****And so forth:**

The expense accounts of a brokerage firm do not differ greatly from those of other businesses.

Balance sheet with security values.—The following balance sheet shows ledger balances and related security

values. The questionnaires required by the various stock exchanges include a balance sheet of this nature, although there is considerable variation in the forms used.

X, Y, AND COMPANY

Balance Sheet With Relative Security Valuations

	BOOK VALUE		MARKET VALUE	
	Debit	Credit	Long Securities	Short Securities and Commitments
Bank Balances	\$ 471,200			
Stock Clearing Funds	75,000			
Money Borrowed		\$11,500,000		\$15,800,000
Stocks Borrowed	6,200		\$ 6,100	
Stocks Loaned		10,500		10,300
Failed to Deliver	14,700		15,200	
Failed to Receive		7,800		7,600
Securities in Box and Transfer				3,157,800
Customers' Accounts:				
Debit Balances:				
Fully secured (This section may be detailed to show different degrees of security)	13,525,000		19,000,000	
Partly secured	89,800		70,000	
Unsecured	10,700		—	
Credit Balances:				
With satisfactory equity (This section also may be detailed)		556,400		373,000
Free credits		325,000		—
Partners' Accounts:				
Individual accounts	130,600	31,600	144,800	24,900
Investment and trading accounts	138,000		137,500	
Capital		2,000,000		
Profit and Loss		115,000		
Exchange Seats	100,000			
Furniture and Fixtures	10,500			
Notes Receivable	3,700			
Revenue Stamps	6,300			
Unclaimed Dividends and Coupons		1,300		
Reserve for Taxes		8,100		
Reserve for Doubtful Accounts		26,000		
	<u>\$14,581,700</u>	<u>\$14,581,700</u>	<u>\$19,373,600</u>	<u>\$19,373,600</u>

QUESTIONS AND PROBLEMS ON CHAPTER 31

QUESTIONS

Question 31-1. What matters should be reduced to agreement in the articles of partnership?

Question 31-2. State five ways of dividing partnership profits.

Question 31-3. *A, B, and C* enter into partnership and agree to invest one half, one fourth, and one fourth of the capital, respectively. They further agree that interest at 6% shall be credited on excess, and charged on deficiency, of capital. The actual investments are: *A*, \$10,000.00; *B*, \$7,000.00; and *C*, \$5,000.00. State what entry or entries should be made at the end of the year for the interest.

Question 31-4. What is the object of allowing interest on capital as a method of dividing part of the profits? Would there be any object in allowing interest on capital if the remaining profits were divided in the capital ratio?

Question 31-5. In examining the partnership accounts of Black and Brown, you ascertain that the capital of \$20,000.00 has been contributed equally, and that the articles of partnership provide that, if any excess capital is supplied by either partner, interest at the rate of 5% per annum shall be allowed. Black pays in \$5,000.00 additional and is credited at the end of the year with \$250.00 interest, which is debited to Brown. State whether you consider this procedure correct, and give reasons for your answer.

Question 31-6. What distinction, if any, would you make between salaries of partners and their drawings as affecting the profit and loss statement?

Question 31-7. State where the following items should appear in the profit and loss statement of a partnership:

Interest on partners' capital.

Interest on one partner's capital in excess of his agreed contribution.

Interest on partners' loans.

Interest on partners' drawings.

Question 31-8. *A, B, and C* are partners. *C* manages the business and is to be allowed a bonus of 20% of the profits as salary. The remaining profits are to be divided equally. The profits, before the bonus is computed, are \$15,000.00. How should they be divided? Discuss contracts of this kind, stating what difficulties may arise in the absence of a specific agreement. Write two forms of agreement, providing, in unmistakable terms, for two different methods of computing the bonus.

PROBLEMS

Problem 31-1. From the following particulars prepare a statement of the capital accounts of the firm of *A, B, and C* for the six months ending June 30, 1934.

Profits are divisible in the following proportions: *A*, 45%; *B*, 30%; *C*, 25%. Interest at 5% per annum is to be credited on capitals. The net profits before adjustment of interest are \$28,600.00. The partners have drawn on the last day of each month as follows: *A*, \$360.00; *B*, \$240.00; *C*, \$200.00. These Drawing accounts have not been charged off. The capitals on December 31, 1933, were as follows: *A*, \$98,000.00; *B*, \$48,000.00; *C*, \$40,000.00.

State also whether, in your opinion, it is necessary to charge interest on the drawings, and give reasons for your opinion, especially with respect to this particular case.

Problem 31-2. *A, B, C, and D* are partners. *A, B, and C* operate separate stores and are entitled to bonuses on the profits of their respective stores, as follows: *A*, 15%; *B*, 10%; *C*, 20%. *D* is in charge of all buying and general administration, and is entitled to a bonus on the profits of each store as follows: *A*'s store, 5%; *B*'s store, 4%; *C*'s store, 2%. The profits of the separate stores, before bonuses were allowed, were:

<i>A</i> 's Store.....	\$10,000.00
<i>B</i> 's Store.. . . .	25,000.00
<i>C</i> 's Store.. . . .	20,000.00
Total...	<u>\$55,000.00</u>

Profits remaining after the bonus payments, are to be divided equally. Prepare statements showing the division of the profits, on the following assumptions:

- (1) The bonuses are not to be regarded as expenses.
- (2) Each managing partner's bonus is to be regarded as an expense of his store, which may be deducted to determine the profits on which his bonus is based; *D*'s bonus is then to be regarded as an expense to be deducted from the

profits remaining after payment of bonuses to managing partners, to determine the profits on which *D*'s bonuses are based.

- (3) Each managing partner's bonus and *D*'s bonus on the profits of each store are to be regarded as expenses which may be deducted to determine the net profits on which bonuses are based.

Problem 31-3. *A*, *B*, and *C* agree to start in business with a capital of \$100,000.00, of which *A* is to furnish \$60,000.00 and *B* and *C* are to furnish \$20,000.00 each. *A* is to have a one-half interest in the business, and *B* and *C* are each to have a one-quarter interest. Interest at 6% is to be credited on excess, and charged on deficiency, of capital. *A* contributes \$60,000.00; *B*, \$15,000.00; *C*, \$18,000.00. Profits for the year are \$20,500.00. How would the Capital accounts stand on the books after closing?

Problem 31-4. *M* and *N* are attorneys in partnership, sharing earnings equally. *R* and *S* are also conducting a law firm, and sharing earnings in the ratio of two thirds and one third. Both firms decide to consolidate on January 1, 1933, on the basis of the following balance sheets:

	<u><i>M</i> and <i>N</i></u>	<u><i>R</i> and <i>S</i></u>
Cash.....	\$ 8,600.00	\$ 4,000.00
Accounts Receivable	20,200.00	22,100.00
Library and Equipment	6,400 00	7,000 00
	<u>\$35,200.00</u>	<u>\$33,100.00</u>
<i>M</i> , Capital	\$15,700.00	
<i>N</i> , Capital.....	19,500.00	
<i>R</i> , Capital		\$24,500.00
<i>S</i> , Capital.....		8,600.00
	<u>\$35,200 00</u>	<u>\$33,100.00</u>

It is agreed that the income shall be recorded in such a manner as to show the amount arising from service to old clients of each firm and from service to new clients; that the expenses shall then be prorated on the basis of the gross earnings from the three classes of clients; that the partners of each old firm shall be entitled to 75% of the net income on service to its former clients, to be divided in the profit and loss ratio formerly existing between them; that interest at 6% shall then be allowed to the old partnerships on their several investments (exclusive of accounts receivable); that the remaining net income shall be divided equally between the two former firms and then to the former members thereof in the profit and loss ratio formerly existing between them; and that losses on

collection of old accounts receivable shall be regarded as losses of the old firms.

At the end of the year it is found that the results have been as follows:

Fees:	
Clients of <i>M</i> and <i>N</i>	\$50,000.00
Clients of <i>R</i> and <i>S</i>	70,000.00
New Clients.....	30,000.00
Expenses.....	45,000.00
Losses on Collections:	
<i>M</i> and <i>N</i> Accounts Receivable	1,800.00
<i>R</i> and <i>S</i> Accounts Receivable.. . . .	3,000.00

Prepare a statement showing the division of the profits, and a statement of partners' capitals.

Problem 31-5. Sam Weiss and Frank Hyde entered into partnership on January 1, 1933, by consolidating their businesses. The assets and liabilities of the two businesses on January 1, 1933, were as follows:

	Weiss' Grocery	Hyde's Market
Assets		
Cash.....	\$ 5,375.00	\$ 4,650.00
Accounts Receivable...	8,725.00	5,640.00
Inventory	5,400.00	1,200.00
Building.....	10,500.00	20,085.00
Furniture and Fixtures	3,200.00	6,060.00
Prepaid Expenses.....	630.00	200.00
	<u>\$33,830.00</u>	<u>\$37,835.00</u>
Liabilities		
Accounts Payable.....	\$ 7,330.00	\$ 5,700.00
Capital.....	26,500.00	32,135.00
	<u>\$33,830.00</u>	<u>\$37,835.00</u>

The businesses occupied adjoining stores. They were operated as departments of the new business, with separate books of account.

Titles to the store buildings were retained in the names of the individual partners, the partnership renting the buildings for two years, at an annual rental of \$2,000.00 for Weiss' store and \$3,000.00 for Hyde's store.

The agreement provides that the partners shall receive interest at 6% on their capital investments, and that the interest credited to each partner shall be chargeable against the profits of his department; if a department shows a profit after the interest charge, 40% of such profit shall be credited to the managing partner as a bonus, and the remainder shall be divided in the ratio of 60% to the managing partner and 40% to the other partner.

The books were kept by single entry, and the following state-

ments were drawn off at the end of the year:

<u>Grocery</u>	
Assets:	
Cash.....	\$ 3,675.00
Accounts Receivable ..	11,250.00
Inventory.....	4,800.00
Furniture and Fixtures.....	3,200.00
Prepaid Rent.....	4,000.00
Other Prepaid Expenses...	525.00
	\$27,450.00
Liabilities:	
Accounts Payable.....	\$ 2,950.00
Due to Market.....	4,500.00
	7,450.00
Net Assets.....	\$20,000.00

<u>Market</u>	
Assets:	
Cash.....	\$ 1,250.00
Accounts Receivable.....	1,800.00
Inventory.....	900.00
Due from Grocery.....	4,500.00
Furniture and Fixtures.....	6,060.00
Prepaid Rent.....	6,000.00
Other Prepaid Expenses.....	125.00
	\$20,635.00
Liabilities:	
Accounts Payable.....	12,175.00
Net Assets.....	\$ 8,460.00

Each partner withdrew \$300.00 per month during the year. It was agreed that the furniture and fixtures should be depreciated at the rate of 15%.

Prepare statements to show the computation of the profit of each department, and the distribution of such profit; a statement of the partners' capital accounts; and a balance sheet of the business, with columns for each department.

Problem 31-6. Bigler, Hawthorne, and Maynard agree to divide their partnership profits in the ratio of the amounts of sales made by each partner, after allowing monthly salaries of \$300.00, \$275.00, and \$250.00, respectively. The partners are to be individually responsible for the cost of merchandise sold on uncollectible accounts.

At the end of a year, their books show:

Bigler's sales.....	\$28,820.00
Hawthorne's sales ..	21,000.00
Maynard's sales.....	30,000.00
Net profits, before charging partners' salaries.....	13,500.00

Bigler and Hawthorne have not drawn their December salaries.

They decide to rescind the salary agreement, treating any salary drawn as an advance, but otherwise dividing the profits according to the original arrangement.

The following facts are to be taken into consideration:

Office furniture costing \$65.00 has been charged to expense.

Funds amounting to \$500.00, lent by Hawthorne, have been credited to his Salary account.

There are unrecorded and unpaid expenses totaling \$375.00.

Accounts receivable of \$320.00 from Bigler's sales are uncollectible.

All sales were made at a gross profit of $66\frac{2}{3}\%$ on cost.

State the journal entries necessary to adjust the accounts; and prepare a corrected Profit and Loss account and a statement of the distribution of the profits.

Problem 31-7. From the following data, prepare:

- A profit and loss statement.
- A balance sheet.
- A statement of partners' capitals.

Trial Balance—December 31, 1933

Cash.....	\$ 8,000.00	
Accounts Receivable—Customers. . .	75,000 00	
Inventory—January 1, 1933..	125,000.00	
Accounts Payable.		\$ 15,000.00
Notes Payable.....		60,000 00
Sales.....		500,000.00
Purchases.....	323,000 00	
Salaries and Store Expenses.....	125,000 00	
Bad Debts.....	2,500 00	
Interest on Notes Payable.....	6,000.00	
Alexander, Salary.....	3,500.00	
Brown, Salary.....	4,000 00	
Clark, Salary.....	3,000.00	
Alexander, Capital.....		50,000 00
Brown, Capital.....		30,000.00
Clark, Capital.....		20,000 00
	<u>\$675,000 00</u>	<u>\$675,000.00</u>

Brown owns the store. The partnership occupies it under an agreement providing for an annual rent of \$6,000.00, payable in advance in monthly installments. The rent has not been paid, and is now to be credited to Brown, together with interest at 6% per annum on the monthly installments.

Of the interest paid on notes payable, \$750.00 applies to the period subsequent to December 31, 1933. There are accrued taxes of \$1,000.00, and accrued wages of \$1,500.00. A reserve of \$1,500.00

is necessary for bad and doubtful accounts. The inventory on December 31, 1933, is valued at \$155,000.00.

Of the profits, if any, after giving effect to those adjustments, 10% is to be credited to Bonuses to Department Managers and Salesmen. Income tax is to be ignored. The bonus is not to be regarded as an expense, in determining the basis of the bonus.

Interest at 6% per annum is to be credited to the partners on their capitals, and remaining profits are divisible in the following proportions:

Alexander	45%
Brown	30
Clark	25

QUESTIONS AND PROBLEMS ON CHAPTER 32

QUESTIONS

Question 32-1. Does the dissolution of a partnership necessarily involve the discontinuance of the business and the distribution of the assets among the partners? Explain fully.

Question 32-2. What is the distinction between buying an interest in a partnership and making an investment in a partnership? How would the records of the two transactions differ?

Question 32-3. How would you record the fact that *F*, with the consent of *B*, bought *A*'s interest in the partnership of *A* and *B* at a price in excess of the amount of *A*'s Capital account?

Question 32-4. Two partners agree to admit a third partner. Before the admission of the new partner, a Goodwill account is to be placed on the books. What entry should be made, and in what ratio will the two original partners be credited? State why this ratio is used.

Question 32-5. *A* and *B* are partners, sharing profits in accordance with their original investments. *A* invested \$5,000.00 and *B*, \$3,000.00, making the capital of the firm \$8,000.00. They sell a one-third interest in the business to *C* for \$8,000.00. How shall *A* and *B* divide the \$8,000.00 received from *C* so that each may retain a one-third interest in the business without increasing or decreasing the original capital of the firm?

Question 32-6. *A* and *B* are equal partners, with capitals of \$20,000.00 each. They agree to admit *C* to a one-third interest in the capital and the profits if he will pay in \$23,000.00. They allow him to decide whether a goodwill of \$6,000.00 shall be placed on the books, in which case he will be credited with the entire \$23,000.00 that he will pay in; or whether no goodwill shall appear on the books, in which case he will be credited with \$21,000.00. He asks your advice as to the better option.

Would your advice be any different if *C* were to have one third of the capital but receive only one fourth of the profits, *A* and *B* sharing the remaining three fourths equally?

PROBLEMS

Problem 32-1. Smith and Bailey have just contributed \$52,500.00 and \$31,500.00, respectively, to a partnership. Morton offers \$48,000.00 for a one-third interest in the capital and profits. The money is to be paid to Smith and Bailey personally, who are to transfer from their Capital accounts to Morton's Capital account sums sufficient to leave a balance of \$28,000.00 at the credit of each partner's Capital account.

At this point a dispute arises over the proper method of dividing the \$48,000.00 between Smith and Bailey. Smith submits the following propositions:

- (1) The \$20,000.00 profit on the transaction should be divided between Smith and Bailey in proportion to the original capital contributions, \$52,500.00 and \$31,500.00, or 62.5% and 37.5%. In support of this division it is contended that the profit is not a partnership profit, because the money is not to remain in the business. Hence the profit and loss ratio does not govern the division of this profit.
- (2) The \$20,000.00 profit should be divided in the ratio in which Smith and Bailey transfer capital credits to Morton: that is, in the ratio of \$24,500.00 and \$3,500.00.

On the other hand, Bailey insists that they are taking Morton in as an equal partner, and giving him an equal share in the capital and profits; therefore what he pays should be divided equally.

How do you think the money should be divided? Give your reasons.

Problem 32-2. A and B are equal partners. Their balance sheet on December 31, 1934, is as follows:

Assets	
Cash.....	\$ 500.00
Accounts Receivable.....	40,000.00
Merchandise Inventory.....	35,000.00
Investments.....	5,000.00
Furniture and Fixtures.....	2,500.00
	\$83,000.00
Liabilities	
Accounts Payable.....	\$31,000.00
Bank Loan.....	15,000.00
A, Capital.....	20,000.00
B, Capital.....	17,000.00
	\$83,000.00

C is to enter the firm. Preliminary thereto, A and B write off bad debts amounting to \$5,000.00, and write off furniture and fixtures 20%, merchandise inventory 10%, and investments 20%. A and B are allowed a goodwill of \$5,000.00.

C will pay in \$10,000.00 for a one-third interest, and the partners are to adjust their capital accounts to equality by personal cash payments.

Give the necessary journal entries, and the balance sheet of the new firm.

Problem 32-3. D. R. Williams and E. C. Forbes, partners, propose to take into partnership B. L. Beatty, who conducts a similar business. The balance sheets of both businesses appear below:

Balance Sheets—October 31, 1935

	Williams and Forbes	B. L. Beatty
Assets		
Cash.....	\$ 550	\$ 680
Accounts Receivable....	1,600	2,100
Inventory.....	8,500	4,200
Store Property.....	10,000	
Furniture and Fixtures....	1,000	800
	<u>\$21,650</u>	<u>\$7,780</u>
Liabilities		
Accounts Payable.....	\$ 3,100	\$1,100
Reserve for Depreciation—Store Property. . .	1,000	
Reserve for Doubtful Accounts...	250	100
D. R. Williams, Capital..	9,300	
E. C. Forbes, Capital.	8,000	
B. L. Beatty, Capital.		6,580
	<u>\$21,650</u>	<u>\$7,780</u>

It is proposed to consolidate the two businesses on the following basis:

Williams and Forbes:

Store Property—Worth New.....	\$13,000
Depreciation.....	2,000
Accounts Receivable—Net Value...	1,200
Goodwill.....	2,000

B. L. Beatty:

Accounts Receivable—Net Value.....	1,700
Furniture and Fixtures Not to be Taken Over—Sold by Beatty for	650

All other assets are taken at book values, and all liabilities are assumed.

Beatty is to contribute enough additional cash to make his capital one half of the combined capitals of Williams and Forbes;

the latter are to adjust their capitals by a cash payment from one to the other, so that all partners will have an equal interest in the capital of the new partnership.

Make all necessary entries on the books of Williams and Forbes to reflect the admission of Beatty under the above-described conditions, and prepare a balance sheet of the new partnership.

Problem 32-4. *A* and *B* invest \$20,000.00 and \$16,000.00, respectively, in a partnership, agreeing to share profits in the capital ratio. They spend \$10,000.00 for equipment and \$26,000.00 for merchandise. Before they actually start business, *C* offers to buy a one-third interest in the business for \$18,000.00. *A* agrees to sell, provided *B* will pay him a bonus of \$2,000.00 out of his (*B*'s) share. *B* agrees, and the sale is made.

How should the \$18,000.00 be divided between *A* and *B* so that the interests of all partners will be equal?

Problem 32-5. K. B. Chester was employed from May 1, 1933, to December 31, 1934, as manager of a retail store owned by Otto Kaye. At the time Chester took charge of the store, the balance sheet of the business was as follows:

Cash.....	\$ 595.00	Accounts Payable.....	\$1,915.00
Accounts Receivable . . .	900 00	Otto Kaye, Capital.....	6,700.00
Inventory	5,120 00		
Fixtures.....	2,000 00		
	<u>\$8,615.00</u>		<u>\$8,615.00</u>

During the period mentioned above, the following transactions occurred:

Merchandise purchases:

For cash.....	\$1,200.00
On account.....	3,965.00

Merchandise sales:

For cash.....	9,500.00
On account.....	5,950.00
Chester's salary paid, \$200.00 per month.	4,000.00
Other expenses paid.....	875.00
Withdrawals by Kaye.....	2,460.00

On December 31, 1934, the trade accounts receivable total \$1,240.00 (after bad accounts of \$280.00 are written off); the trade accounts payable total \$2,650.00; and the inventory is \$3,200.00.

Chester desires to be taken in as a partner, and the following agreement is reached:

- (1) Chester is to pay Kaye \$3,500.00, for which Kaye will transfer one half of his capital as of May 1, 1933.

- (2) Chester is to manage the store, and, in lieu of salary, is to receive a bonus of 40% of profits before bonus and distribution to partners; remaining profits are to be divided equally.
- (3) The above clause is to go into effect as of May 1, 1933, except that, for the past period, interest at 6% per annum is to be allowed Kaye.
- (4) After the books are closed on December 31, 1934, the partner with the lesser capital is to invest enough money to equalize the partners' interests.

Prepare a profit and loss statement (double entry form) for the period (allow depreciation on the fixtures at the rate of 15% per annum); a statement of partners' capitals, showing the contribution required by (4), above; and a balance sheet of the partnership.

QUESTIONS AND PROBLEMS ON CHAPTER 33

QUESTIONS

Question 33-1. *A* and *B* are partners, dealing in wholesale drugs. *A* dies in 1933. His widow objects to a statement offered by *B*, as a basis of settlement, on the ground that the stock of merchandise is listed by *B* at cost, whereas during the six months preceding the death of *A* the average value of the drugs has increased 50% over the original cost. What settlement would you suggest as being equitable, giving your reasons? State how the settlement that you suggest should be dealt with in the books of *B*.

Question 33-2. Mention the chief points to be observed in reporting upon the accounts of a partnership in which you are acting on behalf of a retiring partner, when the business is to be continued by the remaining partners.

Question 33-3. Assume that, at the time of the withdrawal of a partner, it appeared impractical to attempt to value the accounts receivable. It was therefore decided to adjust the withdrawing partner's account at the end of two years and to make final settlement with him at that time with respect to accounts receivable. What method of accounting would you recommend to facilitate the determination of the subsequent payments to be made to the retiring partner?

Question 33-4. *A*, *B*, and *C* are partners, sharing profits equally. *C* is to retire. The goodwill of the business is valued at \$12,000.00. Give journal entries showing two methods of placing the goodwill on the books, and state which method is preferable.

Question 33-5. As bookkeeper for a firm having no articles of partnership, what action would you take on learning of the death of a partner?

Question 33-6. Are there any circumstances under which you would regard it as entirely permissible to defer the closing of the books after the death of a partner until the close of the accounting period?

Question 33-7. *X* and *Y* are partners, having capitals of

\$30,000.00 and \$50,000.00, respectively, and sharing profits equally. They sell their business to a corporation, receiving stock of a par value of \$100,000.00. How should this stock be divided in each of the following cases?

- (a) The contract stipulates that the business shall be sold for the sum of \$100,000.00, payable in stock at par.
- (b) The contract stipulates that the business shall be sold for \$80,000.00, payable in stock of a par value of \$100,000.00.

Question 33-8. The Best Store Company was incorporated for \$50,000.00 on March 31, 1932, by the three partners, A, B, and C. The change in organization was not given effect upon the books. Proprietary interest on January 1, 1932, was \$75,000.00. The profits for the year 1932, determined in January, 1933, are found to be \$10,000.00. Business was uniform throughout the year 1932. State how you would correct this condition on the books in February, 1933.

PROBLEMS

Problem 33-1. The December 31, 1932, balance sheet of Lathrop and Mogg, who shared profits in the ratio of 7 and 3, appeared as follows:

Accounts Receivable.....	\$ 16,300.00	Accounts Payable.....	\$ 16,000.00
Inventory.....	31,000.00	Notes Payable.....	10,000.00
Fixed Assets.....	60,000.00	Bank Overdraft.....	1,300.00
		Lathrop, Capital.....	50,000.00
		Mogg, Capital.....	30,000.00
	<u>\$107,300.00</u>		<u>\$107,300.00</u>

Contingent liability on notes receivable discounted—\$15,000.00.

Lathrop wished to retire, and the assets were taken over by Mogg at the following values:

Accounts receivable.....	\$15,000.00
Inventory.....	30,000.00
Fixed assets..	55,000.00

Mogg assumed all liabilities, and was allowed \$500.00 by Lathrop for accepting sole liability on the discounted notes.

Prepare a statement showing the amount Lathrop should have received from Mogg.

Problem 33-2. The articles of partnership of the firm of Wells and Jones contain the following provisions:

- (a) The books are to be closed on December 31 of each year.
- (b) The Profit and Loss account is to show only operating profits

and is to be closed by credits as follows:

To Wells: 50%.

To Jones: 40%.

To a Reserve for Contingencies: 10%. (This reserve shall be charged with expenses extraneous to operations.)

(c) In the event of the death of a partner, his estate shall be entitled to:

- (1) The capital at his credit at the date of his death.
- (2) His proportion of the reserve for contingencies at the date of his death.
- (3) His proportion of the profits between the date of the last closing and the date of his death—the profits to be based on the average operating profits of the last three completed years.
- (4) Goodwill equal to his share of the net operating profits for the past two completed years.

Wells died on April 1, 1934, at which date his Capital account carried a credit balance of \$25,000.00, and the Reserve for Contingencies carried a credit balance of \$8,550.00.

The following is an analysis of the Reserve for Contingencies:

<u>Credits</u>	
Profits 1930.....	\$1,160 00
Profits 1931.....	2,556.00
Profits 1932.....	3,620.00
Profits 1933.....	<u>3,274.00</u>
	\$10,610.00
<u>Debits</u>	
Fire Loss 1933.....	2,060 00
Balance.....	<u>\$ 8,550.00</u>

State what amount is payable to the estate.

Problem 33-3. White, Burns, Mays, and Allen have been in partnership for three years. Allen now desires to withdraw. The articles of partnership originally provided that the partners should each be permitted to make cash drawings of \$200.00 monthly against profits. These amounts were drawn the first year; the drawings were increased the second year to \$250.00 monthly, and the third year to \$350.00 monthly.

You are called upon to determine the amount to which Allen is entitled. You find that drawings have been charged to Profit and Loss; and that depreciation and bad debts have been recorded incorrectly. It is agreed that proper adjustment shall be made for these items.

An analysis discloses the following facts with regard to bad debt losses:

	<u>First Year</u>	<u>Second Year</u>	<u>Third Year</u>	<u>Total</u>
Losses charged off.....	\$ 600	\$2,820	\$1,505	\$4,925
Reserve now required.....				<u>2,060</u>
Losses as redistributed	2,110	2,205	2,670	<u>\$6,985</u>

Depreciation is to be adjusted on the basis of the following facts:

	<u>Buildings</u>	<u>Equipment</u>
Beginning of first year.....	\$15,250.00	\$4,200 00
Beginning of second year.....	16,950 00	4,200 00
Beginning of third year.....	19,200 00	4,950 00
End of third year.....	21,080.00	6,050.00
Rate of depreciation provided....	2%	5%
Rate of depreciation desired..	4%	10%

Additions during the year were depreciated at one half of the annual rates.

Profits have been credited annually to the partners' Capital accounts in the agreed profit and loss ratios.

Following is an abstract of the Capital accounts:

	<u>White</u>	<u>Burns</u>	<u>Mays</u>	<u>Allen</u>
Investments.....	\$ 8,000	\$20,000	\$12,000	\$20,000
Profits:				
First Year.....	285	855	570	1,140
Second Year.....	660	1,650	1,210	1,980
Third Year....	1,505	3,612	3,010	3,913
Capitals, End of Third Year.....	<u>\$10,450</u>	<u>\$26,117</u>	<u>\$16,790</u>	<u>\$27,033</u>

The partnership agreement provides that, in the event of the withdrawal of any partner by mutual consent at the end of any year, the goodwill of the partnership shall be valued at twice the amount by which the profits of the last year exceed 6% of the partnership capital at the beginning of that year.

Show what amount Allen is entitled to receive.

Problem 33-4. Four partners share profits by allowing interest on capitals at 6% per annum and dividing the remainder equally. The partnership agreement provided that, in the event of the death of any partner, there should be paid to the legal representative of the deceased:

- (A) The balance in his Capital account at the date of his death.
- (B) Minus the balance in his Drawing account at the date of death.

- (C) Plus a share of the profits of the year of his decease, consisting of:
- (1) Interest at 6% per annum on his capital from the preceding December 31 to the date of his death;
 - (2) A share of the remaining profits estimated on the basis of:
 - (a) The average of his share of such remaining profits for the last three completed years.
 - (b) The portion of the year between the date of death and the preceding December 31.
- (D) Plus interest at 6% per annum from the date of death to the following December 31, on the total determined in accordance with paragraphs (A) to (C), inclusive.

The surviving partners were to share the remaining profits equally.

C died on June 30, 1934. The total profits of the three immediately preceding years were \$219,600.00. Each partner had drawn annually in prior years his exact share of the total profits, and no partner had made any additional investments.

With the aid of the following trial balance on December 31, 1934, taken before depreciation has been charged, prepare a profit and loss statement for 1934. Allow \$250.00 for depreciation of office furniture and fixtures, and \$3,000.00 for depreciation of building, plant, and machinery. Also construct a balance sheet, showing what was due to the deceased's estate and what capital stood to the credit of each of the surviving partners.

The inventory on December 31, 1934, was \$125,000.00.

Trial Balance—December 31, 1934

A, Capital.		\$ 120,000.00
B, Capital.		110,000.00
C, Capital.		100,000.00
D, Capital.		90,000.00
A, Drawing.	\$ 12,000.00	
B, Drawing.	12,000.00	
C, Drawing.	5,000.00	
D, Drawing.	12,000.00	
Inventory, December 31, 1933. . .	100,000.00	
Purchases.	1,775,000.00	
Factory Wages and Salaries. . . .	250,000.00	
Discounts Received.		20,000.00
Sales.		2,110,000.00
Cash.	19,500.00	
Bad Debts.	16,000.00	
Notes Receivable.	15,000.00	
Office Salaries.	9,000.00	
General Office Expenses.	2,500.00	

Accounts Receivable...	\$ 414,000.00	
Traveling Expenses	10,000.00	
Taxes—Factory	1,000.00	
Rent and Taxes—Office.	2,000.00	
Land.....	10,000.00	
Building.....	60,000.00	
Plant and Machinery	15,000.00	
Office Furniture and Fixtures . . .	2,500.00	
Notes Payable		\$ 50,000.00
Accounts Payable.		150,000.00
Interest Expense	7,500.00	
	<u>\$2,750,000.00</u>	<u>\$2,750,000.00</u>

Problem 33-5. Whitcomb and Riley were partners whose balance sheet on June 30, 1934, disclosed the following financial condition:

Cash.....	\$ 6,000	Accounts Payable	\$ 40,000
Accounts Receivable	48,000	Notes Payable	45,000
Notes Receivable.....	5,000	Whitcomb, Capital.....	70,000
Inventories.	55,000	Riley, Capital... ..	50,000
Land and Buildings	40,000		
Machinery and Equipment..	48,000		
Furniture and Fixtures..	3,000		
	<u>\$205,000</u>		<u>\$205,000</u>

The business is incorporated as The Whiley Company, on the following plan:

- (1) Capital stock, authorized—\$150,000.00.
- (2) The corporation takes over the entire assets and liabilities of the partnership at the book figures, except: (a) real estate of a book value of \$5,000.00, which is retained by the firm; and (b) the accounts receivable, which are taken over at \$46,000.00.
- (3) \$30,000.00 is allowed for the goodwill of the business.
- (4) Payments to the partnership are made as follows: \$50,000.00 in first mortgage bonds, and the balance in capital stock.
- (5) The remainder of the capital stock is sold for cash at par to sundry persons.

The real estate retained by the partnership is bought by Whitcomb for \$7,000.00; this amount is to be charged to his account.

Prepare:

- (a) Closing entries for the books of the partnership.
- (b) A statement of the partners' accounts.
- (c) Entries to open the books of the corporation.

Problem 33-6. The following data apply to the first three years of a partnership's operations:

	Original Invest- ments	P. and L. Ratio	Drawings
First Year:			
A.....	\$50,000.00	50%	\$6,500.00
B.....	30,000 00	20	5,500.00
C.....	30,000.00	20	5,000.00
D.....	20,000.00	10	2,600.00
Second Year:			
A.....		35	5,800.00
B.....		25	3,900.00
C.....		25	4,100.00
D.....		15	2,700.00
Third Year:			
B.....		30	7,000 00
C.....		30	6,000 00
D.....		20	4,000 00
E.....	<u>30,000.00</u>	<u>20</u>	<u>5,000.00</u>

The profits for the three years, as shown by the books, were \$20,000.00, \$35,000.00, and \$15,000.00.

A died at the end of the second year, and his estate was paid the amount shown to his credit. The estate was explicitly relieved of any further liability with respect to the affairs of the partnership.

E was admitted at the beginning of the third year with an investment as shown above, represented by his personal notes. After the books were closed at the end of the third year, it was found that the inventories had been overstated at each annual closing in the following amounts:

<u>End of Year</u>	<u>Overvaluation</u>
1.....	\$ 3,000.00
2.....	6,250.00
3.....	12,570.00

The notes given by E as representing his investment, and additional notes taken from him during the year in the amount of \$5,000.00, were worthless. Prepare a statement of the partners' accounts, showing how they would appear after adjustment for the above-stated facts.

QUESTIONS AND PROBLEMS ON CHAPTER 34

QUESTIONS

Question 34-1. Why should losses and gains on realization be divided among the partners before any liquidating payments are made to them?

Question 34-2. What is the order of priority in the payment of equities, in the liquidation of a partnership?

Question 34-3. *A* and *B* enter into partnership on January 1, 1933, investing \$20,000.00 and \$16,000.00, respectively, and making no agreement regarding the division of profits. The business is unsuccessful, and it is decided to liquidate. On November 30, after converting all assets into cash and paying all liabilities, the partners find that they have \$27,000.00 in cash to divide. Between January 1, and November 30, 1933, *A* has drawn \$2,000.00 and *B* has drawn \$1,000.00. A dispute then arises concerning the division of the \$27,000.00. *A* claims that the money should be divided in the capital ratio—five ninths and four ninths. *B* contends that, since they made no agreement, they are equal partners, and hence the \$27,000.00 should be divided equally. You are asked for your opinion. Write a letter to the partners, showing how you think the \$27,000.00 should be divided, and giving your reasons.

Question 34-4. State two errors frequently committed in dividing the cash among the partners of a liquidating partnership.

Question 34-5. What is meant by the right of offset in partnership liquidations?

Question 34-6. How should you distribute the cash on hand in liquidating a partnership, if, after charging off losses:

- (a) One partner has a credit balance and the other has a debit balance?
- (b) Two partners have credit balances and one has a debit balance?
- (c) A partner has a debit balance in his Capital account and a credit balance in a Loan account?

Question 34-7. *F* and *G* have capitals of \$25,000.00 and \$3,000.00, respectively. *G* manages the business and is allowed a salary. Two thousand dollars of his salary has not been paid, and it appears as a credit in an account called *G*, Salary. All assets have been realized, all liabilities have been liquidated, and there is \$22,000.00 of cash for division between the partners. State how this money should be divided.

Question 34-8. Because the profit and loss ratio in a given partnership differed from the capital ratio, some of the partners had debit balances and others had credit balances after all losses were charged off. The assets were not sufficient to pay the liabilities. Could the creditors collect from any partner, or would they have to collect from only those partners who had debit balances, on the theory that the partners with credit balances had equities in the partnership assets similar to those of the creditors?

Question 34-9. *A*, *B*, and *C* are in partnership. Their capitals on June 15, 1933, are \$4,000.00, \$20,000.00, and \$34,000.00, respectively. The balance sheet shows assets of \$68,000.00 and liabilities of \$10,000.00. The partnership is dissolved and the assets are sold for \$50,000.00.

A has outside assets of \$2,000.00 and owes outside liabilities of \$3,000.00; *B* has outside assets of \$5,000.00 and owes outside liabilities of \$7,000.00; *C* has outside assets of \$15,000.00 and owes outside liabilities of \$2,500.00.

State the rights of the firm creditors, and of *A*, *B*, and *C*, or their creditors, in the \$50,000.00 received from the sale of the partnership assets.

PROBLEMS

Problem 34-1. Stevens, Carl, Jones, and Brown are partners, sharing profits in the ratio of $\frac{3}{21}$, $\frac{4}{21}$, $\frac{6}{21}$, and $\frac{8}{21}$. The balances of their Capital accounts on December 31, 1933, are as follows:

Stevens.	\$ 1,000.00
Carl	25,000.00
Jones.	25,000.00
Brown	9,000.00
Total	<u>\$60,000.00</u>

The partners decide to liquidate, and they accordingly convert all assets into cash and pay all liabilities. They have \$22,200.00 to divide. How shall it be distributed?

Problem 34-2. *A* invested \$3,000.00 and *B* invested \$4,000.00 in a partnership that is about to dissolve. The firm owes \$6,000.00,

of which \$1,500.00 is due *A*, and \$1,000.00 is due *B*; and has \$8,000.00 in cash. Prepare a statement showing the closing. Profits and losses are to be divided equally.

Problem 34-3. *A*, *B*, and *C* are in partnership. *A* invested \$11,000.00; *B* invested \$5,700.00; and *C* invested \$1,300.00. Their agreement provides that profits or losses shall be divided as follows: *A*, four ninths; *B*, three ninths; *C*, two ninths.

The partnership has become insolvent and is therefore dissolved. The liabilities have been paid, and there is \$9,000.00 of cash on hand as the only asset. How should this cash be divided?

Problem 34-4. Bemis and Burrell are partners, sharing profits and losses equally. The partnership is dissolved on December 31, 1934, at which time the accounts contain the following balances:

Trade Creditors..	\$17,500.00
Bemis, Capital	12,000.00
Burrell, Capital	3,000.00
Bemis, Loan	5,000.00
Burrell, Loan.....	2,500.00

The assets of the firm are disposed of for \$32,000.00 cash. Prepare a statement showing the proper distribution thereof.

Problem 34-5. *D*, *E*, and *F* began business on January 1, 1933, investing \$9,000.00, \$12,000.00, and \$15,000.00, respectively, and agreeing to share profits in the capital ratio.

The bookkeeper undertook to keep a double entry system of accounts, but failed to keep them in balance. It was decided to liquidate the business, and on May 31, 1935, the assets, with the exception of real estate, had been converted into cash. The bookkeeper was told to close the books and to determine the interests of the several partners. He closed the drawings to the Capital accounts and attempted to prepare a trial balance which resulted as follows:

Cash.....	\$15,825.00	
Real Estate.....	4,600.00	
Note Payable, 6%, Dated February 1, 1935, Due in Six Months.....		\$15,000.00
<i>D</i>		4,200.00
<i>E</i>	9,650.00	
<i>F</i>		4,275.00
Sales		16,165.00
Expenses.....	12,875.00	
	<u>\$42,950.00</u>	<u>\$39,640.00</u>

On June 10, 1935, the real estate was sold for \$6,200.00; the

note and interest were paid at maturity.

Prepare a statement showing the several interests of the partners on May 31 and July 31, 1935 (assuming no transactions in the interim other than those indicated above), and the distribution of all cash on July 31.

Problem 34-6. Fred Smith and George White have been in business for three years ending December 31, 1934, on which date they agree to dissolve partnership. Smith takes over the business. White is paid out of partnership funds the amount of his capital at the date of his withdrawal and a sum of \$6,000.00 for his share of the goodwill. Smith has drawn out \$2,000.00 each year and White has drawn \$3,000.00 each year. Smith's capital at the start was \$10,000.00, and White's capital was \$12,500.00. After White's withdrawal. Smith draws up the following condensed balance sheet:

Goodwill	\$6,000.00
Other net assets	3,500 00
Capital	<u>\$9,500.00</u>

Prepare a statement of the partners' capital accounts, showing the amount paid to White upon retirement.

Problem 34-7. G. W. Shelley and S. E. Mayo enter into partnership on January 1, 1933, investing \$24,000.00 and \$18,000.00, respectively, and sharing profits in the capital ratio. They operate two offices, one under the management of each partner. Receipts and disbursements of business cash during the year, handled through the partners' personal bank accounts, are as follows:

	<u>Shelley</u>	<u>Mayo</u>
Receipts.	\$50,925.00	\$41,330.00
Disbursements.	32,140.00	50,965.00

The business, exclusive of any cash, is sold on December 31, 1933, for \$50,000.00. How should the \$50,000.00 be divided between the partners?

QUESTIONS AND PROBLEMS ON CHAPTER 35

QUESTIONS

Question 35-1. Wherein lies the danger of making liquidating distributions to partners before the assets are all realized and the liabilities all paid?

Assume that all partnership liabilities have been paid, but that the partnership assets have not all been realized. How can a liquidator safeguard himself if he wishes to make partial payments to the partners?

Question 35-2. Assume that a partner had a Loan account and a Capital account, and that the sum of the balances of both accounts was less than his possible losses on future realization. The other partner had only a Capital account, but its balance exceeded his possible loss. Would it be permissible to waive the rule requiring payments of loans before capital and to make a payment on the second partner's Capital account before making any payments on the first partner's Loan account?

Question 35-3. You have been appointed liquidator of the firm of *A*, *B*, and *C*, whose balance sheet appears as follows:

Cash.....	\$ 5,000.00	A, Capital.....	\$30,000.00
Other assets.....	45,000.00	B, Capital.	15,000.00
		C, Capital.. . . .	5,000.00
	\$50,000 00		\$50,000.00

State how you would divide the \$5,000.00 cash.

Question 35-4. Referring to the preceding question, assume that *B* and *C* insist that the money should be divided in the capital ratio: \$3,000.00 to *A*, \$1,500.00 to *B*, and \$500.00 to *C*. Explain why this division would be unwise.

Question 35-5. You have been appointed liquidator of the firm of *X* and *Y*, whose balance sheet appears as follows:

Cash.....	\$ 5,000.00	X, Capital.....	\$25,000.00
Other assets.....	40,000.00	Y, Capital.....	15,000.00
		Y, Loan.....	5,000.00
	\$45,000.00		\$45,000.00

To which partner would you pay the \$5,000.00 cash on hand?
Or, would you divide it?

PROBLEMS

Problem 35-1. Prepare working papers and statements of capital accounts showing the first distribution to partners in each of the following cases:

Condition at beginning of liquidation, after payment of liabilities:

Partners	Capitals	PROFIT AND LOSS RATIOS		
		Case 1	Case 2	Case 3
A.....	\$20,000.00	40%	20%	15%
B.....	25,000.00	15	25	35
C.....	15,000.00	15	20	15
D.....	5,000.00	5	15	20
E.....	10,000.00	25	20	15
Total.....	\$75,000.00	<u>100%</u>	<u>100%</u>	<u>100%</u>
Cash for division.....	5,000.00			
Remainder.....	\$70,000.00			
Cash on hand to be held for expenses, etc.	1,000.00			
Non-cash assets.....	<u>\$69,000.00</u>			

Problem 35-2. The condition of a partnership on June 30, 1934, is shown in the following statement:

Cash.....	\$ 5,000.00	
Other Assets.....	105,000.00	
Liabilities.....		\$ 10,000.00
A, Capital.....		13,500.00
B, Capital.....		10,000.00
C, Capital.....		31,500.00
D, Capital.....		15,000.00
A, Loan.....		10,000.00
B, Loan.....		12,000.00
D, Loan.....		8,000.00
	<u>\$110,000.00</u>	<u>\$110,000.00</u>

Losses and gains are shared equally. The non-cash assets are realized in three installments as follows:

	INSTALLMENTS		
	First	Second	Third
Assets realized.....	\$15,000	\$42,000	\$48,000
Loss.....	2,000	6,000	10,000
Cash obtained.....	<u>\$13,000</u>	<u>\$36,000</u>	<u>\$38,000</u>
Expenses paid from the proceeds of realization..	500	800	1,200
Net cash proceeds.....	<u>\$12,500</u>	<u>\$35,200</u>	<u>\$36,800</u>

All cash available after each periodical realization is distributed. Prepare working papers and statement of partners' accounts showing the distributions.

Problem 35-3. *A, B, C, and D* have decided to dissolve partnership. To that end, they have liquidated all their liabilities, and at the date of the first division of cash among the partners the conditions are as follows:

Partners	Partners' Capitals	Partners' Loans	P. & L. Ratio
<i>A</i>	\$24,000.00	\$ 8,000.00	40%
<i>B</i>	21,000.00	6,000.00	30
<i>C</i>	14,000.00	14,000.00	20
<i>D</i>	9,000.00	14,000.00	10
Totals	<u>\$68,000.00</u>	<u>\$42,000.00</u>	<u>100%</u>
Cash available for distribution			\$ 21,000.00
Other assets not yet realized (of doubtful value)			89,000.00
Total			<u>\$110,000.00</u>

State which partners should participate in the distribution of the \$21,000.00; how much cash each should receive; and whether the payments should be applied against the Capital accounts or the Loan accounts. Explain the procedure of determining the distribution. Assume that none of the partners has any private property.

Problem 35-4. *P, Q, R, and S* enter into partnership with a capital of \$100,000.00. *P* invests \$40,000.00; *Q*, \$30,000.00; *R*, \$20,000.00; and *S*, \$10,000.00. They are to share profits and losses in the following proportion: *P*, 40%; *Q*, 25%; *R*, 20%; and *S*, 15%. At the end of six months there is a loss of \$13,000.00; in the meantime the partners have drawn against prospective profits as follows: *P*, \$2,400.00; *Q*, \$1,600.00; *R*, \$1,600.00; and *S*, \$1,400.00.

They dissolve partnership and agree to distribute the proceeds of firm assets. The realization and liquidation lasts four months and the transactions are as follows:

Month	Assets Realized Book Value	Loss On Realization	Liabilities Paid
First	\$ 27,690.00	\$ 500.00	\$ 7,900.00
Second	47,800.00	650.00	6,100.00
Third	17,510.00	240.00	3,800.00
Fourth	7,000.00	210.00	2,200.00
	<u>\$100,000.00</u>	<u>\$1,600.00</u>	<u>\$20,000.00</u>

Prepare a statement showing your recommendations of how the

monthly distributions should be made to the partners.

Problem 35-5. Four partners, who are about to liquidate, close their books and draw off the following statement:

		P. and L. Ratio
A, Capital.....	\$ 40,000.00	30%
B, Capital.....	30,000.00	20
C, Capital.....	40,000.00	20
D, Capital.....	25,000.00	30
Liabilities.....	20,000 00	
Cash.....	\$ 5,000 00	
Other Assets.....	150,000.00	
	<u>\$155,000 00</u>	<u>\$155,000.00</u>

It is agreed that *A*, *B*, and *C* shall be free immediately to enter other businesses, and that *D* shall liquidate the business, and be allowed a commission, payable in cash and chargeable as a partnership expense, of 2% of all cash collected.

The following is a summary of the liquidation. You are to determine the commissions allowable to *D*, and to show the monthly distributions to the partners.

	First Month	Second Month	Third Month	Fourth Month
Assets realized.....	\$40,000	\$35,000	\$30,000	\$45,000
Loss.....	1,000	1,000	1,000	5,000
Cash collected.....	\$39,000	\$34,000	\$29,000	\$40,000
Expenses paid.....	320	320	420	600
Balance.....	\$38,680	\$33,680	\$28,580	\$39,400
Payments to creditors...	8,000	4,000	5,000	3,000
Balance.....	<u>\$30,680</u>	<u>\$29,680</u>	<u>\$23,580</u>	<u>\$36,400</u>

Prepare working papers and a statement of the partners' capital accounts.

QUESTIONS AND PROBLEMS ON CHAPTER 36

QUESTIONS

Question 36-1. State two general methods which may be used to record the transactions of a joint venture, and state what considerations will determine which method will be used.

Question 36-2. Assuming that a separate set of books is to be maintained for a joint venture, describe the record that will be kept on these books and on the books of the participants for:

- (a) Merchandise contributions.
- (b) Cash contributions.
- (c) Expenses paid from the venture funds.
- (d) Expenses paid by one of the participants.
- (e) Sales.
- (f) Cash withdrawals.
- (g) Closing of books and distribution of profit.
- (h) Final cash settlement.

Question 36-3. Assuming that a separate set of books is not to be kept, describe how each participant will record each of the transactions listed in the preceding question.

Question 36-4. How should uncompleted ventures be shown in the balance sheet?

PROBLEMS

Problem 36-1. Joy and Evans were shipping merchandise to Australia on joint account. Evans gave Joy \$3,200.00 in cash and his four-month acceptances in the amount of \$5,000.00. Joy was to provide the balance of the cash required, manage the venture, and receive a commission of 3% of the invoices of merchandise purchased for the venture. Profits were to be divided equally.

Joy paid Plant & Greer \$12,000.00, for merchandise, and discounted Evans' acceptances at a 2% discount, charging the discount to Evans. Joy paid freight, \$450.00, and insurance, \$100.00. In due time Joy received an account sales for merchandise sold and a draft for the net proceeds, \$6,200.00, out of which the acceptances were retired.

Later, Joy received a draft for \$9,100.00, the net proceeds of the

sale of the remaining merchandise. The joint account was closed, and a check for the balance due was given to Evans.

Prepare journal entries, the Joint Venture account, and the account with Evans, as they would appear on the books of Joy.

Problem 36-2. On January 1, 1933, *A*, *B*, *C*, and *D* individually held stock in the Repeal Brewing Company as follows:

<i>A</i>	6,000 shares
<i>B</i>	4,000 shares
<i>C</i>	4,000 shares
<i>D</i>	1,000 shares

The stock had all been acquired at par, \$1.00 per share.

On May 1, 1933, *A*, *B*, *C*, and *D* formed a pool by contributing their holdings thereto at an equitable valuation, and by purchasing from *X* 10,000 shares of the stock of the same company at the market price, \$8.00 per share. The parties were to share equally in the purchase from *X*, and they were to participate in the joint venture in accordance with the shares originally held and with the purchase from *X* on joint account.

In order to buy *X*'s stock on May 1, the entire purchase price was borrowed at 6% on that date from the Wall Street Bank, all the stock held in the pool being given as security for the loan.

On June 10, 1933, the Repeal Brewing Company issued rights to buy one share of stock at \$5.00 for every four shares owned. The pool borrowed money from the bank on June 18, 1933, and took up its rights, depositing the stock with the bank.

Sales of stock were made as follows:

10,000 shares @ \$14.00 per share for settlement June 22.
6,000 shares @ 18.50 per share for settlement June 24.
7,000 shares @ 13.00 per share for settlement July 3.
4,000 shares @ 19.00 per share for settlement July 20.

As the proceeds of the various sales were obtained on the dates mentioned, the bank was paid off and the remaining funds were deposited. The bank charged interest for the actual number of days of the loans, but used 360 days to the year in computing interest.

On July 31, it was decided to wind up the pool and to distribute the stock and cash. Prepare a Joint Venture account showing the result of the above transactions, and a statement of the division of the cash and of the shares unsold, among the participants.

Problem 36-3. Roy Ellis contracts with Owen Young that Ellis is to furnish capital toward the purchase and development of the Rivervale subdivision, and Young is to sell it for their joint

account. Young is to receive no salary for his services, and the profits are to be divided equally.

On May 1, 1932, they purchase the 30 acres comprising the subdivision, at \$3,500.00 per acre, paying one half in cash from Ellis' funds, and giving a 6% mortgage for the balance.

The property is subdivided into 200 lots of equal size, 80 of which are listed to sell at \$900.00 each, and the balance at \$1,200.00 each. In computing the profit on sales, the cost of the two classes of lots is assumed to be in the same ratio as the selling price. Lots may be released from the mortgage by paying to the trustee under the mortgage, cash equal to 125% of the original cost of the lot (computed as indicated above) and the accrued interest on the portion of the mortgage released.

The property is first improved by grading, and so forth, at a cost of \$15,000.00, paid by Ellis.

During July, Ellis and Young sell 61 of the \$900.00 lots and 27 of the \$1,200.00 lots; during August, they sell 15 of the \$900.00 lots and 65 of the \$1,200.00 lots. All of the lots are sold for one-half cash and one-half mortgage notes; the notes are indorsed without recourse and sold to banks at a 3% discount. The lots are released from the purchase money mortgage by payment of the pro-rata amount, releases being obtained and payments to the trustee being made on the last day of each month.

The expenses of advertising and selling, amounting to \$11,000.00, are paid by Young from the proceeds of the sales deposited in his account. He also makes the payments on the mortgage.

Prepare a Joint Venture account showing the record of the transactions. Also prepare a profit and loss statement and a balance sheet after closing the accounts on August 31, 1932.

Problem 36-4. Samuel George, who is in the real estate business, arranges with Y. E. Stevens and Arthur Corona to purchase a parcel of ground and to erect buildings for sale or rent. Contributions of capital and distributions of profits are to be equal.

George takes from Henry Gamble title to 200 feet of land at 3030-34 Simons Avenue for a consideration of \$9,000.00, paying \$4,000.00 cash and giving back mortgages on the property at 3034 for \$2,000.00 and at 3030 for \$3,000.00. He pays \$70.50 for bringing the abstract down and for recording fees.

He sells a 20-foot strip off the back of the property for \$920.00 cash.

Twin houses are erected by Corona on the remaining property at a cost of \$7,015.00 each. A mortgage of \$5,000.00 on each of the pieces of property is executed jointly by the three partners, and the proceeds of the two mortgages are turned over to Corona in

part payment for the houses. The mortgagee, however, deducts \$60.75 insurance premium on the two houses before turning over the proceeds.

George pays Corona \$1,500.00 in cash.

Corona renders a bill of \$810.10 for a garage and extras on the property at 3030.

The property at 3030 is sold to Max Tosty for \$15,150.00, \$500.00 earnest money being received.

Stevens and Corona each pay \$1,000.00 to George, who pays off the original mortgage on this property, plus interest of \$41.10. Tosty then assumes the \$5,000.00 mortgage on the property, including interest amounting to \$210.00, and gives back a second mortgage of \$3,500.00, paying the balance in cash.

The profit on the property sold need not be calculated, nor need separate accounts be opened for the respective pieces.

Record these transactions on the books of George, and draw a trial balance of the syndicate transactions; then show what amount should be paid by one or more members of the joint account to others, to equalize their respective investments.

Problem 36-5. Nine men went on a fishing trip. *A, B, C, D, E, F, G,* and *H* were with the party six days; *K* left at the end of three days. Each was to pay his car fare, fishing license fee, and any personal expenses. The cost of board and room at the resort, guides' fees, bait, tips, and so forth, was to be charged to each member of the party in proportion to the time spent.

The bill rendered by the resort at the end of six days included the following items:

Fishing licenses— <i>B, G, K</i>	\$ 9.00
Board and room	240.00
Guides	60.00
Packing fish for shipment	2.50
Cigars— <i>B</i>	2.00
Long distance telephone— <i>D</i>	1.75
Total	<u>\$315.25</u>

Cash was contributed for the payment of this bill, as follows

<i>A</i>	\$ 50.00
<i>B</i>	45.00
<i>C</i>	30.00
<i>D</i>	55.00
<i>E</i>	40.00
<i>F</i>	29.00
<i>G</i>	25.00
<i>H</i>	41.25
Total	<u>\$315.25</u>

Other payments made by members of the party for group expenses were:

<i>A</i> —Rent of boats at High Lake.	\$ 4.00
<i>D</i> —Rent of boats at Fishtrap Lake.	4.00
<i>E</i> —Airplane ride—As <i>B</i> , <i>F</i> , and <i>K</i> were not on this trip, they are not to be charged with any of the expense.	15.00
<i>H</i> —Tips.	5.00
Total	<u>\$28.00</u>

D was asked to prepare a report showing the final settlement. To those who had paid more than their proportion of the joint expense, he remitted his personal checks; those who had paid less than their proportion of the expense were requested to remit to *D*. Prepare a report such as *D* might have rendered.

QUESTIONS AND PROBLEMS ON CHAPTER 37

QUESTIONS

Question 37-1. State how to set up and close a Fire Loss account, explaining what items should be charged and credited to it.

Question 37-2. Explain why the inventory at the date of a fire may be underestimated by the gross profit method, if the inventory at the date of the last closing was written down to a market value below cost or was written down because of depreciation or obsolescence.

Question 37-3. What is meant by the co-insurance clause? How would you proceed to determine the amount which could be collected under a policy carrying the co-insurance clause?

Question 37-4. A company has insured the life of its president for its own benefit, and is carrying on its balance sheet the amount of premiums paid. What position should an auditor take in regard to these premiums?

PROBLEMS

Problem 37-1. The Jensen Company marks up all merchandise 60% to determine selling prices. The last inventory was taken on December 31, 1931, at which time the cost value of merchandise on hand was \$30,000.00. On May 3, 1934, a fire occurred. The inventory taken immediately thereafter showed:

Undamaged merchandise—marked to sell at \$5,600.00.

Damaged material which can be salvaged—marked to sell at \$3,000.00; estimated value, \$450.00.

On the basis of the following information, determine the loss from the fire:

	YEAR ENDED DECEMBER 31		January 1 to
	1932	1933	May 3, 1934
Sales.....	\$176,000.00	\$205,000.00	\$65,000.00
Less: Discount on Sales.....	\$ 10,000.00	\$ 18,200.00	\$ 6,100.00
Returned Sales.....	8,000.00	6,500.00	2,700.00
Freight Out.....	9,150.00	13,100.00	5,950.00
Total.....	\$ 27,150.00	\$ 37,800.00	\$14,750.00
Net Sales.....	<u>\$148,850.00</u>	<u>\$167,200.00</u>	<u>\$50,250.00</u>

Purchases.....	\$110,000.00	\$135,000.00	\$50,000.00
Less Returned Purchases.....	2,500 00	1,050.00	1,000.00
Net Purchases.....	<u>\$107,500.00</u>	<u>\$133,950.00</u>	<u>\$49,000.00</u>

Problem 37-2. On January 1, 1921, the Schuman Works purchased land for \$15,000.00, erected buildings for \$50,000.00, and acquired machinery costing \$35,000.00. No capital additions were made, and on January 1, 1934, a balance sheet of the company discloses the following financial condition:

Assets		Liabilities	
Cash.....	\$ 10,000	Accounts Payable.....	\$ 30,250
Accounts Receivable..	65,000	Reserves for Depreciation:	
Inventory	30,000	Buildings..	13,000
Land.....	15,000	Machinery...	22,750
Buildings....	50,000	Capital Stock..	100,000
Machinery.....	35,000	Surplus.....	39,000
	<u>\$205,000</u>		<u>\$205,000</u>

On March 10, 1934, the factory is totally destroyed by fire. The books of account as on that date show the following ledger balances:

Cash.....	\$ 15,000	Accounts Payable.....	\$ 21,000
Accounts Receivable	50,000	Reserves for Depreciation:	
Inventory, January 1	30,000	Buildings..	13,000
Land.....	15,000	Machinery.....	22,750
Buildings....	50,000	Capital Stock..	100,000
Machinery.....	35,000	Surplus.....	39,000
Purchases.....	167,000	Sales.....	291,250
Labor and Factory Cost....	60,000		
General Expense.....	65,000		
	<u>\$487,000</u>		<u>\$487,000</u>

For the past three years, the books showed an average rate of gross profit of 30%.

The company succeeds in recovering from the insurance company \$50,000.00 for merchandise. The insurance company acknowledges that replacement cost of the buildings and machinery is higher than book value, and these two items are settled as follows: buildings, \$40,000.00; machinery, \$17,500.00.

The company erects new buildings costing \$60,000.00, and purchases machinery costing \$30,000.00. The land is recorded at its market value of \$25,000.00.

Prepare journal entries to record properly all of the above facts, including losses or gains due to the fire, and actual trading profit from January 1, 1934, to date of fire. Draw up a balance sheet after making the above entries.

Problem 37-3. A company organized January 1, 1934, suffers a total loss of its merchandise just before taking inventory, on December 31, 1936. The books disclose the following facts:

	1934	1935	1936
Inventory, Beginning of Year.....	\$ 78,240.98	\$ 51,894.68	\$ 40,396.40
Purchases.....	195,541.57	235,316.50	157,185.09
Allowances on Purchases.....	13,900.12	19,774.63	7,145.04
Sales.....	262,282.06	291,634.69	178,410.45
Allowances on Sales.....	2,297.37	7,834.50	5,179.25

(a) Determine the value of the merchandise destroyed, and the amounts recoverable under the following concurrent policies containing a 90% co-insurance clause:

X Co.....	\$12,000.00
Y Co.....	15,000.00
Z Co.....	13,000.00

(b) If the merchandise loss had been 50%, what amounts would have been recoverable?

Problem 37-4. A cloak-manufacturing concern, turning out but one grade of cloaks, was robbed on May 7, 1933, and forthwith filed a claim for \$11,200.00 under a burglary insurance policy it was carrying.

The proof of loss filed by the assured contained two items: namely, 400 cloaks valued at \$10,000.00, and 1,000 yards of silk stated to be worth \$1,200.00.

The insurance company, notified of the loss, immediately ordered an inventory to be taken, which disclosed the following quantities on the morning of the eighth:

- 1,050 cloaks.
- 3,250 yards of cloth.
- 2,100 yards of silk.

On the same day, you were called in by the insurance company to examine the books for the purpose of proving or disproving the claim, and obtained the following information:

(1) On January 1, 1933, a complete inventory had been taken of the cloaks, cloth, and silk on hand. While the inventory sheets had subsequently been lost or destroyed, the books showed that the total valuation was \$25,310.00, and the firm's representatives assured you that this was correct and that the inventory had been properly valued at cost prices, which had not fluctuated since.

(2) The cloth and silk purchases since January 1, 1933, had amounted to 10,750 yards of cloth and 3,000 yards of silk at \$.65

and \$1.00 per yard of each fabric, respectively.

(3) Two thousand cloaks had been manufactured during the same period, and 1,800 cloaks had been sold.

You determined that the manufacturing cost was as follows:

Material.....	\$ 8.00	per garment
Labor and other expenses.....	4.50	“ “
Total.....	<u>\$12.50</u>	“ “

Give the gist of your report to your client.

Problem 37-5. You are engaged to prepare amended Federal income tax returns for the calendar years 1933 and 1934, for a client who has been required to change from the cash to the accrual basis. What adjustments are necessary in order to change to the accrual basis, in connection with the following insurance account? Make any other adjustments necessary to correct the books.

Insurance Account—Debits

<u>1933</u>		
May 1	Fire Insurance Premium on Building, Covering Period from May 1, 1933, to April 30, 1935.....	\$ 4,400.00
Aug. 15	Fire Insurance Premium on Stock, Covering Period from July 1, 1933, to June 30, 1934.....	1,800.00
31	Employees' Fidelity Insurance, Covering Period from August 1, 1933, to July 31, 1934.....	6,000.00
Sept. 15	Fire Insurance Premium on Equipment, Covering Period from September 1, 1933, to August 31, 1936 . . .	4,200.00
Oct. 21	Due from Fidelity Insurance Company on Shortage of Bonded Employee.....	1,500.00
		<u>\$17,900.00</u>
<u>1934</u>		
Feb. 1	Premium on Truck Liability Insurance, October 1, 1933, to October 1, 1934*.....	\$ 3,600.00
June 1	Additional Fire Insurance on Building, Covering Period from June 1, 1934, to May 31, 1936.....	2,400.00
Aug. 10	Fire Insurance Premium on Stock, Covering Period from July 1, 1934, to June 30, 1935.....	1,500.00
Nov. 1	Shortage of M. Meyers to be Paid by Fidelity Insurance Company.....	300.00
		<u>\$ 7,800.00</u>

* This policy was renewed for one year at a premium cost of \$3,000.00, which has not yet been paid.

Insurance Account—Credits

<u>1933</u>		
Nov. 1	Refund Due to Reduction in Rate of Employees' Fidelity Insurance.....	\$ 400.00
Dec. 31	Transferred to Profit and Loss.....	17,500.00
		<u>\$17,900.00</u>

<u>1934</u>		
Feb. 1	Recovery from Fidelity Insurance Company on 1933	
	Shortage	\$ 1,500.00
Dec. 31	Transferred to Profit and Loss	6,300.00
		<u>\$ 7,800.00</u>

Your work sheet should indicate clearly the adjusted insurance expense for each of the years affected. Also give the correcting journal entry or entries to bring the client's books into accordance with your amended tax returns. Consideration should be given only to the accounts as stated, and transactions prior to these should be ignored.

QUESTIONS AND PROBLEMS ON CHAPTER 38

QUESTIONS

Question 38-1. Distinguish between a balance sheet and a statement of affairs.

Question 38-2. For what two general purposes may a statement of affairs be prepared? In what way will statements prepared for these two purposes differ?

Question 38-3. What relation does the Deficiency account bear to the statement of affairs?

Question 38-4. Why is the balance sheet classification of assets usually an illogical one to use in a statement of affairs?

How should the asset side of a statement of affairs be classified?

Can you think of any circumstances under which the balance sheet classification of assets might properly be used in a statement of affairs?

Question 38-5. Explain the methods used in a statement of affairs for:

- (a) Offsetting fully secured liabilities and the security.
- (b) Offsetting partially secured liabilities and the security.
- (c) Indicating the special rights of creditors having priority.

Question 38-6. What are valuation reserves? How may they be shown in the statement of affairs and in the Deficiency account?

Question 38-7. A balance sheet is handed you with the request that you prepare a statement of affairs. This balance sheet shows the following items:

Capital stock.....	\$50,000.00
Surplus—January 1.....	12,000.00
Dividends paid during the year.....	10,000.00
Loss for the year.....	19,000.00

How would you show these facts in the statement of affairs and in the Deficiency account?

Question 38-8. Some state laws impose a double liability on

the stockholders. That is, if the corporation becomes insolvent, the stockholders are liable for additional payments equal to the par value of the stock held by them. How would you show this condition in the statement of affairs?

Question 38-9. How would you show in the statement of affairs the contingent liability on notes receivable discounted?

PROBLEMS

Problem 38-1. Prepare a statement of affairs and a Deficiency account as of December 31, 1934, from the following information relative to the financial condition of The Willard Company:

Cash.....		\$ 1,800
Accounts Receivable:		
Good.....	\$ 3,500	
Doubtful (Estimated to Realize 50%).....	500	
Bad.....	<u>900</u>	4,900
Notes Receivable:		
Secured.....	\$ 2,500	
Unsecured (Estimated Value, \$800.00) ..	<u>1,000</u>	3,500
Inventories (Estimated Value, \$30,000.00)...		35,000
Store Furniture (Estimated Value, \$300.00).....		750
Bonds (at Market Value):		
Company B—Pledged to Banks for Loans ..	\$ 7,500	
Company C—Pledged with Notes Payable—Trade Creditors	5,500	
Company A—On Hand ..	<u>3,000</u>	16,000
Deficit ..		<u>29,000</u>
		<u>\$90,950</u>
Accounts Payable.....		\$35,550
Notes Payable:		
Banks.....	\$ 6,000	
Trade Creditors.....	<u>24,000</u>	30,000
Accrued Wages.....		400
Capital Stock.....		<u>25,000</u>
		<u>\$90,950</u>

Problem 38-2. The books of Holmes and Farr, on April 30, 1934, disclosed the following financial condition:

Assets:	
Cash.....	\$ 750.00
Accounts Receivable	39,500.00
Inventory.....	26,800.00
Bonds of X Y Company.....	10,000.00
Land and Building.....	35,000.00
Machinery and Equipment.....	<u>17,500.00</u>
	<u>\$129,550.00</u>

Liabilities and Capital:	
Accounts Payable.	\$ 86,300.00 .
Notes Payable:	
First National Bank.	4,000.00
First State Bank.	6,000.00
Trade.	5,000.00
Accrued Wages.	750.00
Holmes—Capital.	13,500.00
Farr—Capital.	14,000.00
	<u>\$129,550.00</u>

The estimated values of the assets were:

Cash—at Book Value	
Accounts Receivable:	
Good.	\$20,000.00
Doubtful—Estimated Value, 50%.	10,000.00
Bad.	9,500.00
Inventory.	22,000.00
Bonds of X Y Company—at Book Value	
Land and Building.	25,000.00
Machinery and Equipment.	12,500.00

Half of the bonds were held by the First National Bank and the other half by the First State Bank, as collateral to the notes payable. Prepare a statement of affairs and a Deficiency account.

Problem 38-3. The creditors' committee requests you to prepare statements showing what payments can be made to *each* of the several creditors of B. D. Perkins on the basis of the following information as of January 19, 1934:

Creditors:

Employees—\$900.00.

Banks holding notes of \$17,500.00, secured by investment bonds having a book value of \$20,000.00, and an estimated value of \$18,500.00.

Bixby Corporation, holding notes of \$15,000.00 without security, and notes of \$7,500.00 secured by warehouse receipts for finished goods of a book value of \$6,000.00 and an estimated value of \$5,500.00.

Accounts Payable: J. C. Freeman, \$16,500.00; B. F. Johnson, \$1,500.00; Martin and Walton, \$9,500.00.

Assets Not Mentioned Above:

Factory Equipment, \$15,000.00; estimated value, \$10,000.00.

Cash, \$900.00 (includes worthless check of \$300.00).

Stocks of other companies, \$15,000.00; estimated value, \$9,000.00.

Accounts Receivable: Good, \$4,000.00; Doubtful (estimated

to net 50%), \$5,000.00; Bad, \$4,000.00.

- Goods in process and raw materials—book value, \$7,000.00; estimated value, \$4,950.00.

Problem 38-4. From the following data, prepare a statement of affairs to be submitted to a bank in support of an application for an unsecured loan.

THE HAWTHORNE COMPANY

Balance Sheet—August 31, 1933

Assets			
Current Assets:			
Cash.....		\$ 2,135	
Accounts Receivable.....	\$12,300		
Reserve for Bad Debts	975	11,325	
Notes Receivable....	\$ 8,000		
Reserve for Loss.....	500	7,500	
Accrued Interest on Notes....		75	
Inventories:			
Finished Goods.....	\$ 8,300		
Goods in Process.....	6,120		
Raw Materials.....	6,170	20,590	\$ 41,625
Investment in Stock of Davis Corporation.....			12,000
Fixed Assets:			
Land.....		\$ 8,000	
Buildings.....	\$40,000		
Reserve for Depreciation.....	7,500	32,500	
Machinery.....	\$16,000		
Reserve for Depreciation.....	4,500	11,500	52,000
Deferred Charges:			
Unexpired Insurance.....		\$ 400	
Prepaid Interest on Bank Loans.....		50	450
			<u>\$106,075</u>
Liabilities and Net Worth			
Current Liabilities:			
Accounts Payable.....		\$ 7,500	
Notes Payable.....		5,000	
Bank Loans.....		10,000	
Accrued Interest on Mortgage..		275	
Accrued Interest on Notes Payable.....		150	
Accrued Taxes.....		200	\$ 23,125
Mortgage on Land and Buildings.....			15,000
Net Worth:			
Capital Stock.....	\$50,000		
Surplus.....	17,950	67,950	
			<u>\$106,075</u>

The reserve for bad debts is regarded as an adequate provision for losses on accounts receivable. A non-interest-bearing note for \$750.00 is probably uncollectible; the other notes are good.

Finished goods should sell for \$12,000.00. The goods in process will be completed by using materials carried at \$800.00 and by making other expenditures of \$900.00; as finished goods, they should sell for \$9,500.00. The raw materials are conservatively valued in the balance sheet.

The Davis Corporation stock has a market value of \$11,500.00; it has been deposited as collateral to the bank loans.

The land and buildings were appraised on June 30, 1933, at a value of \$27,500.00. The machinery is estimated to be worth \$9,000.00 at forced sale.

Non-interest-bearing notes of a face value of \$6,000.00, regarded as collectible, have been pledged as collateral to the notes payable.

Prepare the asset side of the statement of affairs in two forms:

- (1) Classify the assets in accordance with the balance sheet classifications.
- (2) Classify the assets according to their status as pledged or free.

Problem 38-5. The creditors of the Western Specialties Company are distressed by the decrease in the company's cash and its net worth, as disclosed by the following comparative balance sheet, and ask you to prepare a statement accounting for the change in the company's financial condition.

	DECEMBER 31	
	1934	1933
Assets		
Cash.....	\$ 750	\$ 16,000
Accounts Receivable.....	66,000	48,000
Notes Receivable.....	15,000	20,000
Finished Goods.....	5,000	28,000
Goods in Process.....	20,000	6,000
Raw Materials.....	15,000	38,000
Land and Buildings—Plant.....	75,000	75,000
Machinery and Equipment.....	105,000	85,000
Investment Real Estate.....	75,000	75,000
Goodwill.....	25,000	25,000
	<u>\$401,750</u>	<u>\$416,000</u>
Liabilities, Reserves, and Net Worth		
Accounts Payable.....	\$ 85,000	\$ 10,000
Purchase Money Notes—Balance of \$20,000.00 of Notes Issued in Acquisition of Machinery; Payable \$2,500.00 Monthly.....	15,000	
Accrued Wages.....	500	400
Accrued Taxes.....	2,500	2,000
Notes Receivable Discounted.....	10,000	
Mortgage on Plant Real Estate.....	10,000	10,000

Note Payable—Secured by Mortgage on Investment Real Estate Carried at \$30,000.00; due in Five Years..	15,000	
Note Payable—Secured by Mortgage on Investment Real Estate Carried at \$15,000.00; due in Five Years..	10,000	
Reserve for Bad Debts... ..	8,000	3,000
Reserve for Depreciation—Plant Buildings.....	15,000	12,000
Reserve for Depreciation—Machinery and Equipment..	35,000	27,500
Capital Stock.....	200,000	300,000
Surplus.....	4,250*	51,100
	<u>\$401,750</u>	<u>\$416,000</u>

* Deficit.

The decrease in the capital stock was the result of a donation by each stockholder of one third of his holdings.

Prepare the desired statement.

After studying the statement prepared by you, the creditors engage you to make an investigation of the company's affairs and to submit a statement which will reflect the position of the several creditors. You discover the following facts:

The accounts receivable will probably not realize more than 50% of their face value.

The finished goods can be sold for their stated cost. The goods in process represent a special order (selling price, \$35,000.00) the completion of which will require the use of raw materials carried at \$5,000.00 and other expenditures of \$8,000.00. Raw materials not required for this work will probably realize not more than half of their book value.

The notes receivable on hand are expected to realize \$3,000.00; of those discounted, it is expected that one note for \$4,000.00 will be dishonored by the maker.

The land and buildings occupied for plant purposes can be sold for \$50,000.00. The company which sold the machinery in 1934 will repossess it in settlement of the unpaid balance of the purchase money notes; the remainder of the machinery and equipment will probably bring not more than \$35,000.00.

The investment real estate is worth about 60% of its book value.

QUESTIONS AND PROBLEMS ON CHAPTER 39

QUESTIONS

Question 39-1. What factor will determine whether an assignee, a receiver, or a trustee will open new books or record his transactions on the old books?

Question 39-2. An assignee has been appointed for an insolvent manufacturing corporation whose liabilities and assets consist of its capital stock, notes and accounts payable, unpaid wages, cash, notes and accounts receivable, raw materials, supplies, finished goods, stock in process, plant, and balances against branches. The assignee is temporarily to handle the property as a going concern. You are placed in charge of his accounts. What are the first steps you would take relative to (a) the liabilities, (b) the assets?

Question 39-3. State the entries to be made by the receiver in equity in opening a new set of books, and state what entries should be made on the old books.

What assets does the receiver take onto his books?

Question 39-4. When a receiver in equity takes charge of a business, why is it advisable for him to leave the liabilities on the old books and not to take them onto the new books opened by him?

PROBLEMS

Problem 39-1. The Jackson Company, finding its credit impaired, prepares the following statement, as of January 1, 1933:

Assets		Liabilities and Net Worth	
Cash.....	\$ 2,107.00	Accounts Payable.....	\$480,201.00
Accounts Receivable....	184,216.00	Capital Stock.....	100,000.00
Inventory.....	345,756.00	Surplus.....	200,485.00
Fixed Assets—Net.....	248,607.00		
	<u>\$780,686.00</u>		<u>\$780,686.00</u>

The corporation applied for a receiver; A. L. Sands was appointed and granted permission to operate.

The receiver took over the assets as shown in the above statement, first requiring that the merchandise be written down to \$290,110.00, and the accounts receivable to \$152,600.00.

On May 31, 1934, the receiver had collected all of the accounts receivable taken over, with a further loss of \$12,170.00; had made sales on account of \$350,100.00, and had collected for all of these sales with the exception of \$48,100.00 still carried as accounts receivable. He had paid old accounts payable of \$350,510.00, and receiver's expenses of \$75,415.00. He returned the business to the stockholders on this date, after charging \$18,300.00 as depreciation. There was an inventory of \$41,180.00.

Prepare all entries which should appear on the company's books and on the receiver's books, and submit a balance sheet of the company after the business was returned to the stockholders.

Problem 39-2. On April 15, 1934, Manders Company made a general assignment to A. Lurie, without preference, for the benefit of creditors. The assignee was to continue operations if he considered it advisable, and he therefore opened a new set of books. The assignor's balance sheet on April 15 was:

Assets		Liabilities	
Cash.....	\$ 1,100	Accounts Payable.....	\$25,300
Notes Receivable ...	4,000	First Mortgage Bonds (6% —June 30, Dec. 31).....	10,000
Accounts Receivable (includ- ing \$4,000.00 due from the president).....	12,500	Capital Stock.....	10,000
Inventories.....	9,300	Surplus.....	1,600
Plant.....	20,000		
	<u>\$46,900</u>		<u>\$46,900</u>

By May 1, the assignee had determined that the president's account was uncollectible, that the assets were not worth their book values, and that continued operations and a reorganization were impracticable. He therefore decided to liquidate.

May 7—The inventories were sold for \$5,500.00.

May 21—The accounts receivable were sold for \$6,500.00.

May 31—A 30% dividend was paid.

June 10—Notes receivable for \$3,500.00 were collected, and one note for \$500.00 was settled for \$50.00.

June 30—The plant was sold for \$13,000.00 to the bondholders.

July 5—The assignee paid his fee and expenses, amounting to \$2,400.00, and made a final dividend to the creditors.

Make journal entries in parallel columns, showing the record on the company's books and on the assignee's books. Continue the journal entries until both sets of books are closed.

Problem 39-3. The Cream Company, manufacturers, unable to meet their obligations, suspended payment on January 1, 1933,

and George Sauer was appointed receiver. The books showed the following assets and liabilities:

Assets		Liabilities	
Cash.....	\$ 800	Accounts Payable.....	\$120,285
Notes Receivable....	35,000	Notes Payable.....	115,000
Accounts Receivable .	125,000	Interest on Notes Payable..	2,800
Finished Goods.....	10,000	Accrued Taxes (Estimate)..	900
Goods in Process..	40,000	Mortgage on Land & Bldgs.	100,000
Raw Materials.....	25,000	Interest on Mortgage.....	4,250
Land and Buildings ...	145,000	Reserve for Depreciation..	10,500
Machinery and Tools .	70,000	Capital Stock.....	100,000
Furniture and Fixtures.	10,000	Surplus.....	7,065
	<u>\$460,800</u>		<u>\$460,800</u>

The transactions for the first year of the receivership may be summarized as follows:

Collections on Old Accounts Receivable:	
Total Accounts.....	\$125,000.00
Less: Discounts.....	\$ 500.00
Bad Debts.....	14,000.00
Cash Received.....	<u>\$110,500.00</u>
Collections on Old Notes Receivable.....	<u>\$ 30,000.00</u>
Settlements on Old Notes Payable:	
Total Notes.....	\$115,000.00
Notes Renewed by Company.....	90,000.00
Notes Paid by Receiver..	<u>\$ 25,000.00</u>
Total Interest Paid on Notes.....	<u>\$ 4,100.00</u>
Settlements of Old Accounts Payable:	
Total Old Accounts.....	\$120,285.00
Notes Given by Company.....	65,000.00
Balance.....	\$ 55,285.00
Accounts Paid by Receiver.....	40,000.00
Balance Unpaid.....	<u>\$ 15,285.00</u>
Sales on Account.....	<u>\$380,000.00</u>
Cash Sales.....	<u>18,150.00</u>
Collections on New Accounts Receivable:	
Total Accounts.....	\$380,000.00
Less: Discounts.....	\$ 800.00
Bad Debts.....	2,000.00
Balance.....	<u>\$377,200.00</u>
Cash Received.....	212,000.00
Balance.....	<u>\$165,200.00</u>
Notes Received.....	65,000.00
Balance.....	<u>\$100,200.00</u>

Collections on New Notes Receivable.....	\$ 43,500.00
Cash Purchases of Raw Materials.....	141,000.00
Other Cash Payments:	
Interest on Mortgage for One Year.....	6,000.00
Taxes.....	765.00
Labor.....	115,000.00
Manufacturing Expenses.....	35,000.00
Selling Expenses.....	20,000.00
General Expenses.....	5,000.00

Prepare journal entries as they should appear on the receiver's books and on the company's books; and trial balances of both sets of books.

Following are the inventories and adjustments at the end of the year:

Inventories:	
Raw Materials.....	\$25,000.00
Goods in Process.....	18,000.00
Finished Goods.....	49,000.00
Accrued taxes, estimated.....	750.00
Accrued interest on mortgage.....	4,250.00
Accrued interest on notes payable.....	950.00
Depreciation:	
Buildings.....	3,000.00
Machinery and Tools.....	5,000.00
Furniture and Fixtures.....	500.00

Prepare working papers preparatory to closing the books; statement of cost of goods manufactured and sold; profit and loss statement; and balance sheet.

Problem 39-4. The Gage Company was unable to meet the interest on its bonds due June 30, 1934, and was placed in the hands of Burt Horner, as receiver, by order of the court. Horner took over the assets on the date of the following balance sheet:

Balance Sheet—June 30, 1934

Cash.....	\$ 350	Capital Stock.....	\$ 50,000
Accounts Receivable.....	58,475	First Mortgage 6% Bonds.....	80,000
Finished Goods.....	20,875	Accrued Bond Interest.....	2,400
Goods in Process.....	4,050	Notes Payable.....	45,000
Raw Materials.....	29,500	Accounts Payable.....	47,650
Land.....	30,700	Reserve for Depreciation:	
Buildings.....	95,000	Buildings.....	19,500
Machinery.....	40,000	Machinery.....	20,000
		Res. for Doubtful Accts....	6,200
		Surplus.....	8,200
	<u>\$278,950</u>		<u>\$278,950</u>

The receiver operated the business for six months; his transac-

tions were as follows:

Purchases of Raw Materials.....	\$ 80,000.00
Payments on Account of Above—Cash.....	68,500.00
Discounts Taken on Above.....	850.00
Expense Payments:	
Direct Labor.....	85,100.00
Indirect Labor.....	5,950.00
Factory Expenses.....	8,215.00
Selling Expenses.....	15,250.00
General Expenses.....	2,150.00
Sales on Account.....	185,000.00
Collections on Above Sales (Including Discounts of \$2,800.00)..	148,000.00
Collections on Old Accounts Receivable.....	41,500.00
Payments on Old Accounts Payable—50%.	
Paid bond interest to December 31, 1934, and interest accrued to December 31 on notes payable, at 6%.	

The books were closed on December 31; depreciation was provided as follows: 6% per annum on buildings, and 20% per annum on machinery; and the following inventories were set up:

Goods in Process.....	\$1,500.00
Raw Materials.....	7,600.00
Finished Goods.....	9,900.00

On January 1, 1935, an offer was received and accepted for the sale of all the assets of the business other than cash, on the following basis:

Land.....	\$35,000.00
Buildings.....	45,000.00
Machinery.....	12,000.00
Inventories at 120% of Values Stated Above.	
Accounts Receivable:	
Old Accounts.....	8,000.00
New Accounts.....	35,000.00

The purchaser assumed the mortgage, and paid the balance in cash.

The receiver then paid all liabilities and his own fee of \$5,000.00, and turned the remaining cash back to the company, which distributed it to its stockholders, and dissolved.

Make journal entries in parallel columns, showing all entries necessary to record the foregoing facts as they would appear on the books of the corporation and on the books of the receiver.

QUESTIONS AND PROBLEMS ON CHAPTER 40

QUESTIONS

Question 40-1. Distinguish between a statement of affairs and a realization and liquidation account; between a deficiency account and a realization profit and loss account.

Question 40-2. The realization and liquidation account with its supporting statements should be prepared by a process of journalizing in the statements. Explain what the offsetting debit and credit entries would be with respect to the following:

- (a) Assets, liabilities, and capital at the beginning of the period.
- (b) The discovery of additional assets.
- (c) The sale of merchandise.
- (d) The collection of accounts receivable at a loss.
- (e) The collection of interest on notes.
- (f) The payment of expenses.
- (g) The payment of liabilities.

Question 40-3. John Smith made a composition with his creditors by which it was agreed that all accounts and notes would be settled by payments of sixty cents on the dollar. He owed \$15,000.00 of notes and \$10,000.00 of accounts. A trustee was put in charge, and new notes were given for the reduced amounts agreed upon. Payments of forty cents on the dollar had been made by the time the trustee presented a realization and liquidation account to the creditors. Show how these facts would be set out in the realization and liquidation account.

Question 40-4. In preparing a realization and liquidation account, how would you show:

- (a) Depreciation reserve at the beginning of the period, depreciation charge for the period, and depreciation reserve at the end of the period?
- (b) Discounts allowed to customers?

PROBLEMS

Problem 40-1. The balance sheet of Sanford, Incorporated, on

July 31, 1933, appears below:

		Assets	
Current Assets:			
Cash.....		\$ 270.00	
Accounts Receivable.....	\$33,290.00		
Reserve for Bad Debts.....	<u>1,800.00</u>	31,490.00	
Notes Receivable.....			10,000.00
Inventories:			
Finished Goods.....	\$11,315.00		
Goods in Process.....	7,125.00		
Raw Materials.....	<u>4,125.00</u>	<u>22,565.00</u>	\$ 64,325.00
Fixed Assets:			
Land and Buildings:			
Land.....		\$ 16,500.00	
Buildings.....	\$58,000.00		
Reserve for Depreciation.....	<u>19,500.00</u>	38,500.00	
Machinery and Equipment.....	<u>\$58,000.00</u>		
Reserve for Depreciation.....	<u>18,300.00</u>	39,700.00	
Office Furniture—Less Depreciation.....		<u>4,960.00</u>	99,660.00
Deferred Charges:			
Prepaid Advertising.....		\$ 395.00	
Unexpired Insurance.....		<u>720.00</u>	1,115.00
			<u>\$165,100.00</u>
		Liabilities and Net Worth	
Current Liabilities:			
Accounts Payable.....		\$ 46,875.00	
Notes Payable.....		25,000.00	
Accrued Interest on Notes Payable.....		250.00	
Accrued Interest on Bonds.....		<u>2,400.00</u>	\$ 74,525.00
Fixed Liabilities:			
First Mortgage, 6%, Bonds, Secured by Land and Buildings.....			40,000.00
Net Worth:			
Capital Stock.....		\$100,000.00	
Less Deficit.....		<u>49,425.00</u>	50,575.00
			<u>\$165,100.00</u>

The mortgage interest had not been paid for a year; the current position was poor; and losses had been sustained for some time. It was therefore decided to liquidate. Liquidation required five months, during which period the following transactions took place:

The accounts receivable realized \$29,800.00.

The notes receivable were collected with \$75.00 of interest.

The finished goods were sold for \$13,625.00; the goods in process, for \$4,950.00; and the raw materials, for \$3,650.00.

The land and buildings were sold for \$50,000.00; and the machinery and equipment, for \$32,000.00. The office furniture was taken by a creditor in settlement of an account of \$3,500.00.

A refund of \$280.00 was received on cancellation of the insurance.

All liabilities were settled in full, together with \$125.00 of interest

on notes payable and \$400.00 of interest on bonds, accrued after July 31, 1933.

Expenses of liquidation amounted to \$910.00.

The cash balance on December 31, 1933, was distributed to the stockholders in final liquidation of the company.

Prepare a realization and liquidation account, a cash account, and a profit and loss statement.

Problem 40-2. The Chandler Corporation drew the following balance sheet from its books on September 30, 1933:

Assets		Liabilities	
Cash.....	\$ 150	Mortgage on Land & Bldg..	\$12,000
Accounts Receivable.....	3,130	Interest on Mortgage.....	180
Work in Process.....	24,320	Notes Payable.....	8,500
Raw Materials.....	9,625	Accounts Payable.....	39,750
Bonds of Other Companies..	9,600	Salaries and Wages.....	2,135
Land and Building.....	19,600	Taxes.....	115
Machinery and Equipment..	17,600	Net Worth:	
		Capital Stock...	\$50,000
		Less Deficit.....	28,655
	<u>\$84,025</u>		<u>21,345</u>
			<u>\$84,025</u>

A program of liquidation was decided upon.

During the year ending September 30, 1934, the collections from accounts receivable totaled \$2,500.00; the remaining accounts, with the exception of balances totaling \$350.00, were written off.

Materials valued at \$6,525.00 were used in completing work in process, and payments for labor, in the amount of \$8,300.00, were made for the same purpose. The work in process, when completed, was disposed of for \$38,000.00.

Raw material was sold for \$2,950.00.

Interest amounting to \$75.00 was collected on the bonds owned, and the bonds were sold for \$9,850.00.

The land and building were sold to the holder of the mortgage for \$18,000.00. Additional bond interest amounting to \$90.00 had accrued at the date of the settlement. The company received in cash the excess of the sale price over the principal and interest of the mortgage.

Machinery and equipment carried at \$10,000.00 were sold for \$9,000.00.

All liabilities on September 30, 1933, were settled in full, except notes payable totaling \$3,500.00 and accounts payable totaling \$9,500.00; the total payment for taxes, including the accrual on September 30, 1933, and the subsequent accrual, was \$230.00.

Expenses of liquidation were \$3,115.00.

Prepare a realization and liquidation account, profit and loss statement, and cash account for the year, and a balance sheet as of

September 30, 1934.

Problem 40-3. The stockholders of The Bentley Corporation voted to dissolve the corporation, and authorized the directors to proceed upon a program of realization and liquidation. The balance sheet of the company on December 31, 1933, appeared as follows:

Assets			
Current Assets:			
Cash.....		\$	500.00
Accounts Receivable.....	\$ 48,000.00		
Reserve for Bad Debts.....	1,900 00		46,100.00
Inventories.....		60,000 00	\$106,600.00
Bond Sinking Fund.....			82,000 00
Fixed Assets:			
Land.....		\$ 20,000.00	
Building.....	\$175,000.00		
Reserve for Depreciation.....	8,000.00		167,000.00
Machinery and Equipment.....	\$ 60,000 00		
Reserve for Depreciation.....	18,000 00		42,000 00
Goodwill.....			229,000.00
Goodwill.....			100,000.00
Deferred Charges:			
Miscellaneous.....		\$ 2,500 00	
Unamortized Bond Discount.....		2,000.00	4,500 00
			<u>\$522,100.00</u>
Liabilities and Net Worth			
Current Liabilities:			
Accounts Payable.....		\$ 98,400.00	
Dividends Payable.....		3,000.00	
Bond Interest.....		1,750.00	\$103,150.00
Fixed Liabilities:			
First Mortgage Bonds.....			100,000.00
Deferred Credits:			
Rentals Collected in Advance.....			350.00
Net Worth:			
Capital Stock:			
Preferred.....		\$100,000.00	
Common.....		100,000.00	
Reserve for Contingencies.....		10,000.00	
Sinking Fund Reserve.....		82,000.00	
Surplus.....		26,600.00	318,600.00
			<u>\$522,100.00</u>

By March 31, 1934, the assets had been realized and the liabilities liquidated as follows:

Accounts receivable had realized 80% of their face value.

All accounts payable and dividends payable on December 31, 1933, had been paid.

The merchandise had been disposed of for \$43,500.00.

The machinery and equipment had been sold for \$32,000.00.

Estimated Values:

Land.....	\$ 7,500.00
Buildings.....	38,000.00
Bonds of Company A.....	8,500.00
Merchandise.....	16,000.00
Accounts Receivable:	
\$12,000.00 Good.....	12,000.00
15,000.00 Doubtful.....	9,000.00
3,000.00 Bad.....	0.00
Unexpired Insurance (estimated value to be shown in the statement of affairs).....	75.00

Prepare a statement of affairs and a deficiency account.

The liquidator completed his work on July 31.

The land and buildings sold for \$55,000.00.

The bonds of Company A brought:

Par.....	\$8,800.00
Accrued interest.....	100.00
Total.....	<u>\$8,900.00</u>

The merchandise sold for \$18,000.00.

The accounts receivable realized \$22,000.00.

The insurance policies were canceled, and \$60.00 of returned premiums were received.

The liquidator paid all of the liabilities shown in the balance sheet, as well as \$75.00 interest accrued on the notes payable, and \$100.00 accrued on the mortgage after April 30.

The liquidator paid expenses of \$200.00.

Prepare a realization and liquidation account, a realization profit and loss account, a cash account, and a balance sheet.

How should the cash on hand be divided; that is, what payments should be made to the partners? Assume that payments are made as recommended; prepare a statement of the partners' accounts.

Problem 40-5. The following is the trial balance of the Pittsfield Company on July 31, 1934:

Cash.....	\$ 11,320	Accounts Payable.....	\$ 22,000
Accounts Receivable....	23,400	Interest Accrued on Mortgage	312
Inventories.....	10,350	Mortgage on Real Estate, 6%	26,000
Land and Buildings.....	55,000	Reserves for Depreciation:	
Machinery.....	35,000	Buildings.....	5,000
Furniture and Fixtures..	9,700	Machinery.....	8,000
Tools.....	5,000	Furniture and Fixtures....	5,100
		Capital Stock.....	60,000
		Surplus.....	23,358
	<u>\$149,770</u>		<u>\$149,770</u>

A stockholders' meeting was held on July 31, 1934, and dissolu-

tion was approved. The land and buildings were sold to the mortgagee for \$35,000.00 as of August 15, 1934. On October 1, 1934, the cash book showed:

Debits: Land and buildings, \$8,623.00; machinery, \$24,500.00; tools, \$2,100.00; furniture and fixtures, \$3,700.00; accounts receivable, \$21,000.00; inventories, \$8,000.00.

Credits: Accounts payable, \$22,000.00; expenses, \$1,600.00.

Prepare a realization and liquidation account, a cash account, a realization profit and loss statement, and a balance sheet before the distribution of cash to the stockholders.

PROBLEMS ON CHAPTER 41

Problem 41-1. Refer to problem 40-1, and prepare a statement of realization, liquidation, and operations.

Problem 41-2. Refer to problem 40-2, and prepare a statement of realization, liquidation, and operations.

Problem 41-3. Refer to problem 40-3, and prepare a statement of realization, liquidation, and operations.

Problem 41-4. Refer to problem 40-4, and prepare a statement of realization, liquidation, and operations.

Problem 41-5. Refer to problem 40-5, and prepare a statement of realization, liquidation, and operations.



QUESTIONS AND PROBLEMS ON CHAPTER 42

QUESTIONS

Question 42-1. State what entry is made by the home office in taking up the profit of a branch, and explain the theory underlying this entry. State, and explain the reason for, the entry taking up a branch loss.

Question 42-2. A firm having several branches maintains an account in its ledger with each branch, and charges to such accounts all goods sent to the branches for stock. At the end of the year the balance of each branch account is treated as an ordinary account receivable, and is included in the balance sheet with the general debts owing to the firm. If you see any objection to this method, state it, and state also how you would deal with the accounts.

Question 42-3. Outline the instructions you would give to afford the main office of a company adequate control over expenditures at its various plants for additions and replacement repairs, and to insure uniform and correct accounting treatment thereof.

Question 42-4. A company having several branches desires to charge each branch with interest on the average capital invested in the branch. State how these entries will be made on the home office books. What effect will such entries have on the branch profits, and on the profits of the concern as a whole?

Question 42-5. A trading and mining company maintains five general stores at five separate stations, and concentrates its supplies each year at Station A, which is the only station accessible by railway; distribution is made from this station by means of wagon and pack trains. The cost of goods laid down at Station A is 10% above the invoice prices at the company's general office in Montana, and the agent at Station A is instructed to rebill all shipments to Station B at 20%, to Station C at 35%, to Station D at 40%, and to Station E at 50% above original invoice cost, since the experience of several years bears out the general manager's statement that such additions are approximately correct and cover actual cost of transportation.

In auditing the accounts for the purpose of certifying the annual

balance sheet, you ascertain that certain goods of Station *D*, amounting to \$10,000.00, are inventoried by the agent at that point at 70% above the original invoices, which you have examined at the home office. He states that Station *E*, being overstocked, shipped him several lots of merchandise at the price billed out to *E* by Station *A*, plus 10% for estimated cost of handling and repacking at *E*; and to this amount, *D* legitimately added 10% for cost of transportation from *E* back to *D*.

In your visits to other stations you find many similar instances in which goods have been moved back and forth, and each time the shipping station has added 10% for handling and repacking.

Of a total inventory at all stations of goods originally costing \$200,000.00, the summary shows final extensions of values aggregating \$325,000.00, of which not more than \$75,000.00 is covered by the cost of direct transportation, leaving approximately \$50,000.00 represented by internal charges added between the different stations.

Review the foregoing statement, and give your method of handling such accounts.

PROBLEMS

Problem 42-1. The Mercedes Company, of New York City, operates branches at Pittsburgh, Omaha, and Denver. The branches keep their own accounts receivable and remit all collections to the main office at New York. All branch expenses, including salaries and wages, are paid by the branches from working funds that are kept at a fixed balance by draft on the main office.

The following information applicable to the year ended December 31, 1933, is supplied by the branches:

	Pittsburgh	Omaha	Denver
Sales (on account).....	\$187,000	\$171,000	\$163,000
Returned sales.....	2,500	1,400	
Expenses paid.....	38,500	36,950	36,750
Bad debts.....		1,250	600
Cash collected from customers.....	168,500	162,600	153,500
Accounts receivable—December 31, 1932....	95,000	85,500	70,000
Accounts receivable—December 31, 1933 ..	111,000	91,250	78,900
Working fund.....	2,500	2,500	2,500
Inventory—December 31, 1932.....	35,000	39,000	36,500
Inventory—December 31, 1933.....	43,000	47,000	45,000
Goods received from main office.....	135,000	118,000	123,500

From these details, prepare:

- (a) A statement of branch assets on December 31, 1932, and balances of current accounts.
- (b) The closing entries for the Pittsburgh branch.

- (c) The main office current account on the Pittsburgh books.
- (d) The journal entry on the main office books, taking up the Pittsburgh branch profit; and the Pittsburgh Branch Current account on the main office books.
- (e) A combined branch profit and loss statement.
- (f) A statement of branch current accounts on the main office books; and lists of assets represented by balances on December 31, 1933.

Problem 42-2. The following statements were rendered by the Lansing branch to the home office at Milwaukee:

Comparative Balance Sheet

	<u>DECEMBER 31</u>	
	<u>1932</u>	<u>1933</u>
Assets		
Cash Working Fund.....	\$ 1,000	\$ 1,500
Accounts Receivable.....	31,940	31,315
Merchandise.....	76,375	86,600
Furniture and Fixtures.....	5,000	5,500
Deferred Charges.....	200	250
	<u>\$114,515</u>	<u>\$125,165</u>
Liabilities		
Accrued Salaries.....	\$ 300	\$ 250
Reserve for Doubtful Accounts..	850	1,025
Reserve for Depreciation..	1,500	2,100
Home Office Current....	111,865	121,790
	<u>\$114,515</u>	<u>\$125,165</u>

Profit and Loss Statement
Year Ended December 31, 1933

Sales.....		\$271,170
Deduct:		
Returned Sales and Allowances.....	\$ 1,045	
Freight Out Paid.....	860	1,905
Net Sales.....		<u>\$269,265</u>
Deduct Cost of Goods Sold:		
Inventory, January 1, 1933.....	\$ 76,375	
Merchandise from Home Office.....	231,270	
Total.....	\$307,645	
Less Inventory, December 31, 1933.....	86,600	221,045
Gross Profit on Sales.....		<u>\$ 48,220</u>
Deduct:		
Salaries.....	\$ 15,325	
Depreciation of Buildings.....	3,750	
Depreciation of Furniture and Fixtures.....	600	
Provision for Bad Debts.....	525	
Interest Charged by Home Office.....	4,500	
Other Expenses.....	1,800	
Home Office Overhead Charged to Branch.....	5,000	31,500
Net Profit.....		<u>\$ 16,720</u>

Merchandise is billed to the branch at cost. All cash received from customers is remitted to the home office. Fixed assets, other than furniture and fixtures, are carried on the home office books at a value of \$75,000.00 and depreciated at the rate of 5% per annum. Additions to furniture and fixtures are purchased and paid for by the home office. Expenses are paid by the branch from the working fund, which is replenished by draft on the home office.

Prepare: (1) an analysis of the Home Office Current account for the year, which should accompany the foregoing statements; and (2) all entries (in journal form) on the home office books for the establishment of a reciprocal Branch Current account.

Problem 42-3. On January 1, 1932, the Perfection Manufacturing Company established a branch at Springfield, Missouri, under the management of J. G. Whitely. Merchandise was billed to Whitely at 130% of cost, one sixth of the amount thus added to cost representing shipping expenses to the branch. Whitely remitted to the home office all proceeds of sales and collections of accounts receivable; he paid expenses from a working fund of \$500.00, which was replenished regularly from the home office. The home office sent him a check for \$250.00 each month as an advance, it being understood that at the end of the year he should be allowed 30% of the net profit as shown by the branch books (without regarding these monthly advances as an expense), and that any difference between the manager's share of profit and his advances should be payable by or to the company.

On December 31, 1932, Whitely submitted the following statements to the home office:

Branch Profit and Loss Statement, 1932

Sales.....		\$165,000.00
Less Cost of Goods Sold:		
Merchandise Received.....	\$182,000.00	
Less Inventory, December 31, 1932	<u>44,200.00</u>	137,800.00
Gross Profit.....		\$ 27,200.00
Expenses.....		18,000.00
Net Profit..		<u>\$ 9,200.00</u>

Branch Assets

Cash.....	\$ 500.00
Accounts Receivable.....	12,000.00
Merchandise.....	<u>44,200.00</u>
Total.....	<u>\$ 56,700.00</u>

The home office statements for the year appear on the following page.

THE PERFECTION MANUFACTURING COMPANY

Profit and Loss Statement

Year Ended December 31, 1932

Sales:		
To J. G. Whately.....	\$182,000.00	
To Other Customers.....	<u>635,000.00</u>	
Total.....		\$817,000.00
Less Cost of Goods Sold:		
Inventory, January 1, 1932.....	\$105,000.00	
Cost of Goods Manufactured.....	<u>678,000.00</u>	
Total.....		\$783,000.00
Less Inventory, December 31, 1932	<u>110,000.00</u>	673,000.00
Gross Profit on Sales.....		\$144,000.00
Expenses.....		<u>48,000.00</u>
Net Profit.....		<u>\$ 96,000.00</u>

THE PERFECTION MANUFACTURING COMPANY

Balance Sheet—December 31, 1932

Assets		Liabilities	
Cash.....	\$ 15,650	Accounts Payable.....	\$ 40,000
Accounts Receivable:		Capital Stock.....	400,000
J. G. Whately.....	50,500	Surplus.....	83,150
Other Customers.....	35,000		
Inventories.....	110,000		
Plant—Depreciated Value...	312,000		
	<u>\$523,150</u>		<u>\$523,150</u>

Give journal entries to adjust the company's books to a proper basis. (The books have been closed.) Prepare an adjusted profit and loss statement with columns for home office, branch, and combined, and a balance sheet.

Problem 42-4. The following is a trial balance of December 31, 1933, taken from the books of The Black and White Company:

Imprest Fund.....	\$ 1,000.00	
Union Trust Company.....	18,500.00	
First National Bank.....	10,500.00	
Accounts Receivable.....	50,000.00	
Notes Receivable.....	13,000.00	
Merchandise Inventory, January 1, 1933.....	200,000.00	
Branch Controlling Account.....	60,000.00	
Reserve to Reduce Branch Inventory, Dec. 31, 1932, to Cost.....		\$ 5,000.00
Investments in Bonds.....	25,000.00	
Prepaid Insurance.....	2,000.00	
Land.....	25,000.00	
Buildings.....	125,000.00	
Machinery and Equipment.....	100,000.00	
Furniture and Fixtures.....	5,000.00	

Depreciation Reserve		\$ 11,750 00
Accounts Payable.....		62,500 00
Notes Payable		200,000 00
Accrued Taxes		1,500 00
Accrued Interest.....		1,250 00
Chas. Adams.....		16,000 00
William Black.....		18,000 00
Thomas Clark.....		20,000 00
George Dunn.....		14,000 00
C. H. Evans.....		22,000 00
Common Stock.....		200,000 00
Surplus.....		25,500 00
Sales.....		299,500 00
Returned Sales.....	\$ 7,500 00	
Purchases.....	150,000 00	
Pay Roll	35,000 00	
Manufacturing Expense.....	25,000 00	
Taxes Paid.....	2,500 00	
Salaries.....	20,000 00	
Office Expense.....	4,500 00	
Discount Allowed.....	1,500 00	
Discount Earned.....		1,500 00
Interest Expense	7,500 00	
Interest Earned.....		500 00
Branch Profit—1933.....		9,500 00
Dividends Paid.....	20,000 00	
	<u>\$908,500 00</u>	<u>\$908,500 00</u>

Home office inventory, December 31, 1933, \$191,000.00

The following transactions occurred on December 31, 1933, but had not been entered on the company's records:

(1) The company was granted an increase in its capital as follows:

\$200,000.00—7% cumulative preferred stock, par value \$100.00 per share.

\$100,000.00—additional issue of common stock, par value \$100.00 per share.

(2) The board of directors authorized the sale of all of the preferred stock at \$95.00 per share, using the proceeds received on December 31 to reduce the company's notes payable and directing that the discount of \$5.00 per share be charged to Surplus. It also authorized the sale of the unissued common stock pro rata to the stockholders of record at \$100.00 per share.

The common stock holdings before the above transactions were made, were as follows:

Chas. Adams.....	310 shares
William Black.....	408 shares
Thomas Clark.....	492 shares
George Dunn.....	290 shares
C. H. Evans.....	500 shares

(3) The common stock holders requested that their personal accounts be charged with the cost of the common stock purchased by them.

Shipments have been billed to the branch during the past several years at a uniform rate of write-up on cost. The branch manager rendered the following statements as of December 31, 1933:

Balance Sheet—December 31, 1933

Assets	
Cash.....	\$ 8,500.00
Accounts Receivable.....	18,500.00
Notes Receivable.....	4,000.00
Merchandise Inventory.....	30,000.00
Prepaid Insurance.....	500.00
	<u>\$61,500.00</u>
Liabilities and Net Worth	
Accounts Payable.....	\$ 1,250.00
Accrued Taxes.....	250.00
Home Office.....	60,000.00
	<u>\$61,500.00</u>

**Profit and Loss Statement
Year Ended December 31, 1933**

Sales.....	\$119,500.00
Deduct:	
Inventory, December 31, 1932... \$ 25,000.00	
Merchandise from Home Office... 100,000.00	
Total.....	<u>\$125,000.00</u>
Less Inventory, December 31, 1933 30,000.00	<u>95,000.00</u>
Gross Profit.....	\$ 24,500.00
Deduct Expenses.....	15,000.00
Net Profit.....	<u>\$ 9,500.00</u>

Depreciation should be provided as follows: 2% on buildings, 5% on machinery and equipment, and 7½% on furniture and fixtures. A reserve of \$1,000.00 is also to be provided for bad and doubtful notes and accounts receivable.

Prepare journal entries covering the foregoing transactions, a profit and loss statement, and a surplus statement for the year 1933; and a balance sheet as of December 31, 1933, after the consummation of all transactions referred to. The profit and loss statement may show the branch profit as a single item. The balance sheet should combine the home office and branch balance sheets.

Problem 42-5. The following is a trial balance of The Gaudel Manufacturing Company on December 31, 1933, at the close of its first year's operations:

Cash.....	\$	40,000	
Accounts Receivable.....		51,000	
Branch Current.....		143,000	
Machinery and Equipment.....		400,000	
Reserve for Depreciation.....	\$		25,000
Accounts Payable.....			83,000
Notes Payable.....			150,000
Capital Stock.....			700,000
Sales (to customers and branch, 80,000 units at \$10.00)			800,000
Raw Materials Purchased.....		600,000	
Productive Labor.....		200,000	
Non-Productive Labor.....		50,000	
Manufacturing Supplies and Expenses.....		100,000	
Selling Expense.....		80,000	
Administrative Expense.....		80,000	
Interest Paid.....		8,000	
Discounts Earned.....			6,000
Discounts Allowed.....		12,000	
		<u>\$1,764,000</u>	<u>\$1,764,000</u>

The inventories on December 31, 1933, determined from accurate records of material and labor, with overhead applied at an estimated direct-labor-cost rate, were as follows:

	Productive			Total
	Material	Labor	Overhead	
Raw Materials.....	\$125,000			\$125,000
Work in Process.....	30,000	\$40,000	\$36,000	106,000
Finished Goods (20,000 units).....	60,000	50,000	45,000	155,000

The raw materials on hand have a market value of only \$100,000.00. The estimated labor and factory expenses used in computing the rate of overhead were as follows:

Productive labor.....	\$200,000.00
Non-productive labor.....	\$ 60,000.00
Supplies and expenses.....	96,000.00
Interest on machinery and equipment.....	24,000.00
Total.....	<u>\$180,000.00</u>

The branch office reports the following ledger balances on December 31:

Cash.....	\$	3,000
Accounts Receivable.....		40,000
Purchases from Home Office: 60,000 units @ \$10.00.....		600,000
Sales: 50,000 units.....		\$500,000
Home Office Current Account.....		143,000
		<u>\$643,000</u>
		<u>\$643,000</u>

Ten thousand units were on hand at the branch office on Decem-

ber 31, 1933. The unit costs of material and labor in the branch inventory were the same as those in the home office inventory.

Prepare a statement of cost of goods manufactured and sold, a profit and loss statement, journal entries to close the home office books, working papers combining the home office and branch balance sheets, and a balance sheet.

QUESTIONS AND PROBLEMS ON CHAPTER 43

QUESTIONS

Question 43-1. What is the purpose of a consolidated balance sheet? How does a consolidated balance sheet differ from a balance sheet prepared from the parent company's books?

Question 43-2. Why is a consolidated balance sheet superior to a balance sheet of the parent company showing the Investment account?

Question 43-3. If the parent company pays more than book value for the subsidiary stock, how is the excess shown on the consolidated balance sheet? Justify this treatment.

Question 43-4. State the amount of the goodwill and of the minority interest in the following case and explain how you obtained your figures. The subsidiary has a capital stock of \$100,000.00 and a surplus of \$50,000.00. The parent company acquired 90% of the stock and paid \$140,000.00 for it. A consolidated balance sheet is to be made at the date of acquisition.

Question 43-5. Assume that the subsidiary had a surplus at the date of acquisition of its stock by the parent company, and that the parent company bought all of the stock, paying exactly book value for it. What eliminations would be made in preparing a consolidated balance sheet at the date of acquisition?

Question 43-6. Assume that the subsidiary had a deficit at the date of acquisition, and that the parent company bought all of the stock, paying par less the deficit. What accounts should be eliminated in making a consolidated balance sheet at the date of acquisition?

Question 43-7. Assume that the parent company acquired 98% of the stock of the subsidiary, and that a balance sheet is to be made at the date of acquisition. Assume also that the parent company paid exactly book value for its holding, as shown by the books of the subsidiary. State how the elimination should be made and how the minority interest should be determined in each of the following cases:

- (a) The subsidiary had no surplus.
 (b) The subsidiary had a surplus.
 (c) The subsidiary had a deficit.

PROBLEMS

Problem 43-1. On January 1, 1934, Company *P* acquired for \$150,000.00 the entire capital stock of Company *S*, consisting of 1,000 shares of \$100.00 par value each. After the transaction had been recorded on the books of Company *P*, the trial balances of the two companies were as follows:

	Company <i>P</i>	Company <i>S</i>	
Land.....	\$ 50,000	\$ 25,000	
Buildings.....	100,000	45,000	
Investment in Company <i>S</i>	150,000		
Inventories.....	80,000	20,000	
Accounts Receivable.....	70,000	85,000	
Accounts Payable.....	\$100,000		\$ 50,000
Capital Stock.....	250,000		100,000
Surplus.....	100,000		25,000
	<u>\$450,000</u>	<u>\$450,000</u>	<u>\$175,000</u> <u>\$175,000</u>

Prepare a consolidated balance sheet.

Problem 43-2. On June 30, 1934, the Monroe Company purchased 85% of the stock of the Dearborn Company. Trial balances of the two companies immediately after the purchase were as follows:

	Monroe Company	Dearborn Company
<u>Debits</u>		
Cash.....	\$ 8,500.80	\$ 11,305.50
Accounts Receivable.....	45,600.15	51,159.90
Notes Receivable.....	5,600.00	4,131.25
Inventories.....	61,506.05	31,510.40
Investment in Dearborn Company..	93,500.00	—
Machinery and Equipment.....	49,105.00	33,135.50
Goodwill.....	20,000.00	15,000.00
	<u>\$283,812.00</u>	<u>\$146,242.55</u>
<u>Credits</u>		
Accounts Payable.....	\$ 47,160.10	\$ 13,708.80
Reserve for Bad Debts.....	3,151.00	—
Reserve for Depreciation.....	22,350.70	10,155.65
Capital Stock.....	150,000.00	100,000.00
Surplus—Earned.....	37,650.20	22,378.10
Surplus—Donated.....	23,500.00	—
	<u>\$283,812.00</u>	<u>\$146,242.55</u>

Prepare a consolidated balance sheet.

Problem 43-3. On December 31, 1933, the balance sheet of Healy Company appeared as follows:

Assets			
Current Assets:			
Cash.....		\$ 15,000	
Accounts Receivable:			
Adler Company.....	\$12,000		
Others.....	30,000	42,000	
Inventory.....		40,000	\$ 97,000
Fixed Assets:			
Cost.....		\$ 71,000	
Reserve for Depreciation.....		15,000	56,000
Deferred Charges.....			2,000
			<u>\$155,000</u>
Liabilities and Net Worth			
Current Liabilities:			
Accounts Payable.....			\$ 30,000
Net Worth:			
Capital Stock—Authorized, 2,000 shares; in treasury, 1,000 shares; outstanding, 1,000 shares.....			
		\$100,000	
Surplus.....		25,000	125,000
			<u>\$255,000</u>

On the date of the above balance sheet the Adler Company acquired at 150 a large block of the outstanding stock of Healy Company; after this purchase had been recorded, the books of Adler Company contained the following balances:

Cash.....	\$ 10,000.00	
Accounts Receivable....	67,000.00	
Inventory.....	51,000.00	
Investment in Healy Company.....	135,000.00	
Plant.....	215,000.00	
Accounts Payable.....		\$ 45,000.00
Healy Company.....		12,000.00
Notes Payable (secured by Healy stock).....		75,000.00
Reserve for Depreciation.....		90,000.00
Preferred Stock.....		100,000.00
Common Stock.....		200,000.00
Surplus.....	44,000.00	
	<u>\$522,000.00</u>	<u>\$522,000.00</u>

Prepare a consolidated balance sheet as of December 31, 1933.

Problem 43-4. On July 1, 1934; the Marco Corporation acquired all of the stock of the Armeo Corporation, a customer, for \$77,000.00, payable 50% in cash and 50% by a six-month note. The balance sheets of the two companies on that date, before giving effect to the stock purchase, were as follows:

PROBLEMS ON CHAPTER 43

	<u>Marco Corporation</u>	<u>Armeo Corporation</u>
Current Assets.....	\$150,000.00	\$ 55,000.00
Fixed Assets.....	90,000.00	43,000.00
Investments.....	15,000.00	5,000.00
Other Assets.....	7,500.00	8,000.00*
	<u>\$262,500.00</u>	<u>\$111,000.00</u>
Current Liabilities.....	\$ 30,000.00	\$ 50,000.00
Capital Stock.....	200,000.00	50,000.00
Surplus.....	32,500.00	11,000.00
	<u>\$262,500.00</u>	<u>\$111,000.00</u>

* Including a claim for \$5,000.00 against the Marco Corporation for overcharge on purchases, never recognized or set up by the latter company.

Prepare a consolidated balance sheet as of July 1, 1934.

QUESTIONS AND PROBLEMS ON CHAPTER 44

QUESTIONS

Question 44-1. Describe the method that a parent company should use in recording the profits, losses, and dividends of a subsidiary. Explain why this is the proper procedure.

Question 44-2. A corporation owns 85% of the stock of one company, and three shares out of a total of one hundred shares of another company. In what way, if at all, would its records differ in regard to profits earned and dividends paid by the two companies?

Question 44-3. A subsidiary has capital stock of \$100,000.00 and surplus of \$50,000.00. The parent company buys 90% of the stock and pays \$138,000.00 for it. What elimination should be made in preparing a consolidated balance sheet at the date of acquisition, and what is the amount of the goodwill and the minority interest?

Assume that, during the first year after purchase, the subsidiary makes a profit of \$20,000.00. What entries should be made to take up the profits?

What would be the balances of the Investment account on the parent company's books, and the Surplus account on the subsidiary's books, at the end of the first year of ownership?

State what elimination should be made and the amount of goodwill, minority interest, and surplus to be shown in the consolidated balance sheet prepared at the end of the year.

Question 44-4. Refer to the preceding question and assume that during the second year the subsidiary lost \$10,000.00. State how the parent company should take up the loss. Also state the balances in the Investment account and the subsidiary's Surplus account at the end of the second year.

How would you make the elimination in preparing a consolidated balance sheet, and what would be the amount of the goodwill and the minority interest? How would you determine the amount of the surplus to appear on the consolidated balance sheet?

Question 44-5. Continuing the preceding question, assume that, just prior to the close of the second year, the subsidiary

declared a dividend of \$9,000.00, payable the following year. What entry should be made by the parent company?

What are the balances of the Investment account and the subsidiary's Surplus account?

Explain how eliminations would be made in preparing a consolidated balance sheet, and state the amount of the goodwill and the minority interest.

State how the surplus to be shown in the consolidated balance sheet would be determined, and whether the declaration of the dividend by the subsidiary would alter the amount of surplus to be shown in the consolidated balance sheet.

PROBLEMS

Problem 44-1. On January 1, 1934, Company A acquired 85% of the stock of Company X at 160 per share. The net worth of Company X on that date was reflected by the following balances:

Capital Stock, \$150,000.00 Surplus, \$75,000.00

Also on January 1, 1934, Company A acquired 90% of the stock of Company Y at 130 per share. The net worth of Company Y at that date included:

Capital Stock, \$100,000.00 Surplus, \$25,000.00

During 1934, Company X made a profit of \$30,000.00 and paid a dividend of \$9,000.00; Company Y lost \$5,000.00 and paid a dividend of \$6,000.00.

Prepare, in journal form, the entries to be made by Company A to record the acquisition of the stocks, the shares of subsidiary profit and loss, and the subsidiary dividends received.

Also prepare working papers to determine the goodwill, minority interests, and consolidated surplus to appear in a consolidated balance sheet on December 31, 1934. The surplus of Company A on that date, before taking up the profit and loss of the subsidiaries, was \$72,000.00.

Problem 44-2. The following facts are submitted relative to Company P and its subsidiaries, Companies A, B, and C, whose stocks were acquired by Company P on January 1, 1934:

	Com- pany P	Com- pany A	Com- pany B	Com- pany C
Par value of stock outstanding	\$300,000	\$100,000	\$50,000	\$50,000
Portion of stock owned by Company P		90%	85%	80%
Surplus, January 1, 1934	60,000	30,000	40,000	25,000
Cost to Company P of stock acquired.		125,000	80,000	65,000
Profit (Loss*), 1934	30,000	20,000	5,000*	10,000
Dividends paid, 1934	10,000	6,000	3,000	15,000

The \$30,000.00 profit of Company *P* is the profit before subsidiary profits and loss have been taken up.

Prepare a statement of the parent company's Investment accounts and its Surplus account for the year, including therein the proper entries for the parent company's interests in subsidiary profits and loss.

Also determine the amounts which should appear in a consolidated balance sheet on December 31, 1934, for:

- Goodwill.
- Minority interests.
- Consolidated surplus.

Problem 44-3. Following are the trial balances of Gary Company and its subsidiaries on December 31, 1933, after closing:

<u>Debits</u>	Gary Company	Royal Company	Cooper Company
Cash.....	\$ 45,200	\$ 16,780	\$ 34,400
Accounts Receivable..	61,800	33,400	61,050
Inventory	87,800	41,150	55,400
Investment in Royal Company—850 shares	98,100		
Investment in Cooper Company—950 shares.	166,700		
Plant and Equipment...	203,300	113,500	154,750
Goodwill.....	25,000	40,000	
	<u>\$687,900</u>	<u>\$244,830</u>	<u>\$305,600</u>
<u>Credits</u>			
Accounts Payable.....	\$102,050	\$ 43,130	\$ 63,600
Due to Gary Company.....		12,500	10,000
Bonds Payable.....	100,000		
Reserve for Depreciation....	54,500	60,200	91,500
Capital Stock (Par value \$100.00 per share)..	400,000	100,000	100,000
Surplus.....	6,350	29,000	40,500
Sinking Fund Reserve.....	25,000		
	<u>\$687,900</u>	<u>\$244,830</u>	<u>\$305,600</u>

Prepare consolidated working papers and a balance sheet.

Problem 44-4. The Mull Company owns 90% of the stock of the Rice Company and 100% of the stock of the Weld Company; it takes up through its Investment accounts the profits, losses, and dividends of the subsidiaries.

On June 30, 1934, the accounts of the three companies contain the following balances:

<u>Debits</u>	Mull Company	Rice Company	Weld Company
Investment in Weld Company.....	\$111,000.00		
Goodwill.....	10,000.00	\$40,000.00	
Surplus.....	25,000.00	25,000.00	

PROBLEMS ON CHAPTER 44

<u>Credits</u>	<u>Mull Company</u>	<u>Rice Company</u>	<u>Weld Company</u>
Investment in Rice Company.....	\$ 2,500.00		
Capital Stock.....	500,000.00	\$50,000.00	\$50,000.00
Surplus.....			50,000.00

What amounts of goodwill, minority interest, and surplus will appear in the consolidated balance sheet as of June 30, 1934?

QUESTIONS AND PROBLEMS ON CHAPTER 45

QUESTIONS

Question 45-1. Assume that a parent company purchased stock at a time when a dividend had been declared but not paid. The purchase was made before the date on which the stock records were to be closed to determine the stockholders of record. How should the parent company record the purchase of the stock?

Question 45-2. What are the two general methods used by parent companies in carrying investments in subsidiaries? Which method is preferable, and why?

Question 45-3. A parent company carries its investment in a subsidiary at cost. To what extent will its account balances differ from those which would result from taking up subsidiary profits, losses, and dividends through the Investment account?

Question 45-4. When the parent company carries its subsidiary investment at cost, on what basis should intercompany eliminations be made in the working papers?

PROBLEMS

Problem 45-1. Prepare a consolidated balance sheet as of December 31, 1935, from the following data:

COMPANY A		
Balance Sheet—December 31, 1935		
Cash.....	\$ 75,000.00	
Accounts Receivable.....	450,000.00	
Inventory.....	<u>400,000.00</u>	\$ 925,000.00
Investment in Company B—1,800 Shares Purchased April 30, 1935, for.....		315,000.00
Machinery and Equipment.....		510,000.00
Total.....		<u><u>\$1,750,000.00</u></u>
Accounts Payable.....		\$ 675,000.00
Capital Stock.....		500,000.00
Surplus, January 1, 1935.....	\$380,000.00	
Profits for Year.....	<u>320,000.00</u>	
Total.....	<u>\$700,000.00</u>	
Less Dividends Paid in February, 1935.....		<u>125,000.00</u>
Total.....		<u><u>\$1,750,000.00</u></u>

COMPANY B

Balance Sheet—December 31, 1935

Cash.....	\$ 25,000	
Accounts Receivable.....	55,000	
Inventory.....	115,000	\$195,000
Machinery and Equipment.....		477,000
Total.....		<u>\$672,000</u>
Accounts Payable.....		\$292,000
Capital Stock, 2,000 Shares.....		200,000
Surplus, January 1, 1935.....	\$120,000	
Profits (Earned Proportionately throughout the Year)	60,000	180,000
Total.....		<u>\$672,000</u>

Problem 45-2. On December 31, 1932, Company X purchased 850 shares (85%) of the \$100.00 par value stock of Company Y, at \$150.00 per share. Following is an abstract of the Surplus accounts of the two companies for the two subsequent years:

	Company X	Company Y
Balance, December 31, 1932.....	\$75,000.00	\$40,000.00
1933: Profits.....	15,000.00	7,000.00
Dividends Paid.....	9,000.00*	6,000.00*
Dividends Received.....	5,100.00	
Balance, December 31.....	<u>\$86,100.00</u>	<u>\$41,000.00</u>
1934: Profits.....	8,000.00	3,000.00*
Dividends Paid.....	9,000.00*	4,000.00*
Dividends Received.....	3,400.00	
Balances, December 31.....	<u>\$88,500.00</u>	<u>\$34,000.00</u>

* Debit.

Determine the minority interest, goodwill, and consolidated surplus to appear in the consolidated balance sheets as of:

- (a) December 31, 1933.
- (b) December 31, 1934.

Problem 45-3. On January 1, 1934, Company A acquired 95% of Company B's stock and 90% of Company C's stock at the prices shown in the following balance sheets as of June 30, 1934:

	BALANCE SHEETS		
	Company A	Company B	Company C
Assets			
Current Assets.....	\$ 750,000	\$ 310,000	\$ 75,000
Plant Property.....	910,000	1,000,000	600,000
Goodwill.....			35,000
Investments in Subsidiaries:			
Company B.....	975,000		
Company C.....	625,000		
	<u>\$3,260,000</u>	<u>\$1,310,000</u>	<u>\$710,000</u>

Liabilities			
Current Liabilities.....	\$ 360,000	\$ 250,000	\$ 10,000
Capital Stock.....	2,250,000	1,000,000	400,000
Surplus, January 1, 1934.....	525,000	30,000	250,000
Net Profit, Six Months Ended June 30, 1934.....	125,000	30,000	50,000
	\$3,260,000	\$1,310,000	\$710,000

Prepare a consolidated balance sheet.

Problem 45-4. Prepare a consolidated balance sheet, from the following data:

Balance Sheets—December 31, 1934				
	Company <u>W</u>	Company <u>X</u>	Company <u>Y</u>	Company <u>Z</u>
Assets				
Current Assets.....	\$1,825,000	\$ 545,000	\$ 250,000	\$ 535,000
Investments in Subsidiaries—At Cost:				
Company X—75% ..	850,000			
Company Y—80% ..	475,000			
Company Z—90% ..	1,000,000			
Fixed Assets.....		550,000	725,000	550,000
Deferred Charges.....		25,000	35,000	25,000
	\$4,150,000	\$1,120,000	\$1,010,000	\$1,110,000
Liabilities and Net Worth				
Current Liabilities.....		\$ 100,000	\$ 300,000	\$ 100,000
Capital Stock.....	\$3,000,000	600,000	800,000	800,000
Surplus.....	1,150,000	420,000	90,000*	210,000
	\$4,150,000	\$1,120,000	\$1,010,000	\$1,110,000

* Deficit.

The investment in Company X was acquired on January 1, 1931; since that date, Company X has made profits of \$550,000.00, and paid dividends of \$144,000.00.

The investment in Company Y was acquired on July 1, 1929; at that date, Company Y had a deficit of \$375,000.00.

The investment in Company Z was acquired on July 1, 1931. The Surplus account of Company Z is summarized as follows:

Balance, December 31, 1931.....	\$130,000.00
Profits for four years (assumed to have been earned in equal monthly amounts).....	400,000.00
Total.....	\$530,000.00
Less Dividends—\$80,000 Paid Annually on June 30	320,000.00
Balance, December 31, 1934.....	\$210,000.00

Problem 45-5. Following are the balance sheets of three affiliated companies on December 31, 1935:

	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>
Cash.....	\$ 10,000.00	\$12,000.00	\$ 8,000.00
Accounts Receivable.		27,000.00	14,000.00
Inventories.....		18,000.00	13,000.00
Investments in Subsidiary Companies:			
Company B (425 Shares)	60,000.00		
Company C (400 Shares)	52,000.00		
Plant and Equipment.....		40,000.00	30,000.00
	<u>\$122,000.00</u>	<u>\$97,000.00</u>	<u>\$65,000.00</u>
Accounts Payable...	\$ 7,000.00	\$15,000.00	\$12,000.00
Capital Stock—\$100 Par Value...	100,000.00	50,000.00	50,000.00
Surplus.....	15,000.00	32,000.00	3,000.00
	<u>\$122,000.00</u>	<u>\$97,000.00</u>	<u>\$65,000.00</u>

Company A has recorded all dividends received by credits to the Investment accounts; it has taken up through the Investment accounts all subsidiary profits and losses except those of the year ended December 31, 1935, which are reflected in the following statement:

Analysis of Surplus

	<u>Company B</u>	<u>Company C</u>
Balance, January 1, 1935...	\$22,000.00	\$15,000.00
Net Profit (Loss*).....	20,000.00	9,000.00*
Total.....	<u>\$42,000.00</u>	<u>\$ 6,000.00</u>
Dividends Paid....	10,000.00	3,000.00
Balance, December 31, 1935.. . . .	<u>\$32,000.00</u>	<u>\$ 3,000.00</u>

Prepare a consolidated balance sheet as of December 31, 1935.

QUESTIONS AND PROBLEMS ON CHAPTER 46

QUESTIONS

Question 46-1. A parent company holding notes receivable from a subsidiary company to the extent of \$100,000.00 indorses and discounts these notes with its bankers, thus creating a contingent liability thereunder. State how and where the liability would appear, if at all, in a consolidated balance sheet of the two companies.

Question 46-2. State how you would treat the following item in preparing a balance sheet of the parent company, and a consolidated balance sheet: "Dividends declared and receivable on stock of a subsidiary company."

Question 46-3. A parent company owns 90% of the capital stock of a subsidiary company. The directors of the subsidiary company pass a resolution appropriating surplus earnings as dividends and direct the treasurer to remit to the parent company whenever surplus funds are available. The subsidiary company earns \$60,000.00, which it pays to the parent company. What are the rights of interested parties and how should they be shown on the consolidated statements?

Question 46-4. In the process of consolidating several competing establishments, Corporation *A*, the parent company, acquires \$98,000.00 of a total of \$100,000.00 of the capital stock of Company *B*. At the time of the purchase, the balance sheet of Company *B* showed surplus and undivided profits of \$50,000.00. Corporation *A* bought the stock of *B* at 200%. Almost immediately after the purchase, Company *B* paid a cash dividend of 25%. In what way would the payment of this dividend affect:

- (a) The balance sheet of *B*?
- (b) The balance sheet of *A*?
- (c) The consolidated balance sheet of *A* and its subsidiaries?

Question 46-5. A company owns all of the capital stock of another company. This subsidiary company has outstanding an issue of bonds not guaranteed by the company holding the stock. The assets of the subsidiary company are deemed insufficient to

cover the bonds, so that its capital stock has no value. The parent company desires the auditor to prepare its balance sheet, setting up the assets of this subsidiary company, as well as other assets directly owned, and the bonds as liabilities. Under the circumstances, is the auditor justified in preparing such a balance sheet? Give reasons for your answer.

PROBLEMS

Problem 46-1. From the data given below, as of September 30, 1934, prepare a consolidated balance sheet:

	Company A	Company B	Company C
Assets			
Cash.....	\$ 27,000.00	\$ 10,000.00	\$ 45,500.00
Notes Receivable.....	45,000.00	10,000.00	20,000.00
Accounts Receivable.....	65,000.00	25,000.00	150,000.00
Inventories.....	126,000.00	50,000.00	382,750.00
Advances to Company A.....			50,000.00
Advances to Company B.....	25,000.00		
Stock of A:			
Common (cost \$110.00 a share)			173,250.00
Stock of B:			
Common (cost \$90.00 a share)			36,000.00
Bonds of Company B.....	45,000.00		
Plant and Equipment.....	240,000.00	150,000.00	750,000.00
Deferred Charges.....	3,000.00	5,000.00	15,000.00
	<u>\$576,000.00</u>	<u>\$250,000.00</u>	<u>\$1,622,500.00</u>
Liabilities			
First Mortgage Bonds.....		\$ 85,000.00	\$ 300,000.00
Notes Payable.....	\$ 66,000.00		34,000.00
Accounts Payable (including advances from affiliated companies).....	75,000.00	35,000.00	110,000.00
Dividends Payable.....	875.00		
Accrued Bond Interest Payable..		2,550.00	6,000.00
Reserve for Depreciation.....	100,000.00	40,000.00	150,000.00
Capital Stock:			
Preferred (Non-Participating)	50,000.00	25,000.00	250,000.00
Common.....	175,000.00	50,000.00	500,000.00
Surplus.....	109,125.00	12,450.00	272,500.00
	<u>\$576,000.00</u>	<u>\$250,000.00</u>	<u>\$1,622,500.00</u>

An examination of the records of Company A shows that on September 30, 1934, that company advanced to Company B \$10,000.00, which was not received and taken up on the records of the latter until October 2, 1934.

Surplus of subsidiaries at the dates of stock acquisition:

Company A.....	\$65,000.00
Company B.....	—

The Dividends Payable appearing on the books of Company A represents a quarterly dividend of \$.50 a share of its common stock, declared September 20, 1934, payable on October 20, 1934, to stockholders of record on September 30, 1934. Dividends on the preferred stocks of all companies have been paid to September 30, 1934.

It is the custom of all three companies to take up income from investments on their books only when received.

All capital stock, both preferred and common, has a par value of \$100.00 a share.

Problem 46-2. From the following balance sheets and explanatory data, prepare a consolidated balance sheet:

COMPANY X

Balance Sheet—December 31, 1931

Assets	
Cash.....	\$ 20,000.00
Investment in Company Y—1,400 shares, profits taken up annually, dividends credited as received.....	210,000.00
Investment in Company Z—4,000 shares, at cost, January 1, 1931.....	<u>200,000.00</u>
	<u>\$430,000.00</u>
Liabilities and Net Worth	
Current Liabilities.....	\$ 40,000.00
Collateral Gold Notes, due 1939.....	100,000.00
Capital Stock—	
Preferred: 1,000 shares, par value \$100.00.....	100,000.00
Common: 10,000 shares, no par value.....	150,000.00
Surplus.....	<u>40,000.00</u>
	<u>\$430,000.00</u>

COMPANY Y

Balance Sheet—December 31, 1931

Assets	
Cash.....	\$ 60,000.00
Receivables.....	100,000.00(1)
Inventories.....	<u>100,000.00</u>
	<u>\$260,000.00</u>
Liabilities and Net Worth	
Current Liabilities.....	\$ 36,000.00(2)
Capital Stock—	
2,000 shares, par value \$100.00.....	200,000.00
Surplus—	
Balance, January 1, 1931.....	\$40,000.00
Add Profit for Year.....	<u>14,000.00</u>
	<u>\$54,000.00</u>
Less Dividends.....	<u>30,000.00</u>
	<u>\$260,000.00</u>

COMPANY Z

Balance Sheet—December 31, 1931

Assets	
Cash.....	\$ 55,000.00(3)
Receivables.....	40,000.00
Inventories.....	100,000.00
Land, Buildings, and Equipment as appraised by General Appraisal Co., December 31, 1931, at sound value of.....	113,000.00
	<u>\$308,000.00</u>
Liabilities and Net Worth	
Current Liabilities.....	\$ 83,000.00
Capital Stock—	
5,000 shares, par value \$50.00.....	250,000.00
Deficit—	
Balance, January 1, 1931.....	\$100,000.00
Profit for Year 1931.....	75,000.00
	<u>25,000.00*</u>
	<u>\$308,000.00</u>

Notes:

- (1) Includes \$25,000.00 due from Z Company.
- (2) Includes 10% dividend payable January 4, 1932.
- (3) After remitting \$25,000.00 to Company X on December 30, 1931; the check was not received by X until January, 1932.

Problem 46-3. Following are trial balances after closing on December 31, 1933, for Auto Sales Corporation, Green Motor Car Company, and Motor Bodies, Incorporated. Prepare a consolidated balance sheet.

AUTO SALES CORPORATION

	Debits	Credits
Cash.....	\$ 127,510	
Advances to Subsidiaries.....	346,800	
Stock of Green Motor Car Co.....	500,000	
Stock of Motor Bodies, Inc.....	165,000	
Bonds of Green Motor Car Co. (par \$100,000.00).....	85,000	
Bonds of Motor Bodies, Inc. (par \$50,000.00).....	52,000	
Cars on Hand.....	400,000	
Accounts Receivable.....	260,000	
Notes Receivable.....	700,000	
Fixtures and Equipment.....	125,000	
Improvements on Leased Property, Proportion Chargeable to Future Operations.....	25,000	
Common Stock.....		\$1,000,000
Preferred Stock.....		500,000
Surplus.....		295,000
Reserve for Losses on Accounts Receivable.....		71,310
Notes Receivable Discounted.....		650,000
Reserve for Contingent Losses.....		100,000
Accounts Payable.....		40,000
Reserve for Depreciation.....		45,000
Green Motor Car Co.—Current Account.....		85,000
	<u>\$2,786,310</u>	<u>\$2,786,310</u>

GREEN MOTOR CAR COMPANY

	<u>Debits</u>	<u>Credits</u>
Patent Rights.....	\$ 750,000	
Machinery and Tools.....	300,000	
Land and Buildings.....	200,000	
Fixtures and Other Equipment.....	50,000	
Cars Completed.....	100,000	
Cars in Process.....	250,000	
Materials and Unassembled Parts.....	175,000	
Auto Sales Corporation—Current Account.....	85,000	
Accounts Receivable.....	9,700	
Cash.....	80,000	
Motor Bodies, Inc., Stock.....	50,000	
Capital Stock.....		\$ 750,000
Bonds Payable.....		750,000
Surplus.....		126,000
Accounts Payable.....		74,000
Reserve for Depreciation of Fixed Assets.....		24,700
Notes Payable for Advances.....		200,000
Motor Bodies, Inc.—Current Account.....		125,000
	<u>\$2,049,700</u>	<u>\$2,049,700</u>

MOTOR BODIES, INC.

	<u>Debits</u>	<u>Credits</u>
Land and Buildings.....	\$100,000.00	
Machinery and Tools.....	75,000.00	
Building Fixtures.....	35,000.00	
Completed Bodies.....	50,000.00	
Bodies in Process.....	75,000.00	
Materials.....	86,800.00	
Green Motor Car Co.—Current Account.....	125,000.00	
Accounts Receivable.....	7,500.00	
Patents.....	200,000.00	
Cash.....	50,000.00	
Capital Stock.....		\$250,000.00
Bonds Payable.....		250,000.00
Surplus.....		45,000.00
Dividends Payable (January 15, 1934).....		7,500.00
Accounts Payable.....		65,000.00
Reserve for Depreciation.....		40,000.00
Notes Payable for Advances.....		146,800.00
	<u>\$804,300.00</u>	<u>\$804,300.00</u>

All of the intercompany stockholdings were acquired at par on the dates of organization of the subsidiary companies.

Problem 46-4. The Artex Company acquired 22,500 shares of common capital stock of The Burnam Corporation as of December 31, 1926, at a cost of \$2,000,000.00. On June 30, 1928, it acquired 4,000 shares of the common capital stock of The Plymouth Machine Company at \$200.00 a share. The balance sheets of the two

companies at the dates of acquisition of their stocks were as follows:

THE BURNAM CORPORATION
Balance Sheet—December 31, 1926

Assets	
Cash.....	\$ 300,000.00
Customers' Notes and Accounts.....	700,000.00
Inventories.....	800,000.00
Land.....	125,000.00
Buildings.....	500,000.00
Machinery and Equipment.....	750,000.00
Prepaid Expenses.....	25,000.00
	<u>\$3,200,000.00</u>
Liabilities	
Notes and Accounts Payable.....	\$ 200,000.00
Federal Income Taxes Payable.....	30,500.00
Accrued Interest.....	3,000.00
Other Accrued Expenses.....	1,500.00
Reserve for Depreciation.....	200,000.00
Reserve for Doubtful Accounts.....	15,000.00
Capital Stock:	
Preferred—4,500 shares (par value \$100.00)...	450,000.00
Common—30,000 shares (no par value)....	1,500,000.00
Surplus.....	800,000.00
	<u>\$3,200,000.00</u>

THE PLYMOUTH MACHINE COMPANY
Balance Sheet—June 30, 1928

Assets	
Cash.....	\$ 150,000.00
Customers' Notes and Accounts.....	300,000.00
Inventories.....	450,000.00
Land.....	50,000.00
Buildings.....	200,000.00
Machinery and Equipment.....	370,000.00
Discount on First Mortgage Bonds.....	26,443.00
Prepaid Expenses.....	15,000.00
	<u>\$1,561,443.00</u>
Liabilities	
Notes and Accounts Payable.....	\$ 150,000.00
Federal Income Taxes Payable.....	15,000.00
Accrued Interest:	
On First Mortgage Bonds.....	9,208.00
On Notes Payable.....	1,235.00
Other Accrued Expenses.....	1,000.00
Fifteen-Year 6½% First Mortgage Bonds due 1940	425,000.00
Reserve for Depreciation.....	100,000.00
Reserve for Uncollectible Accounts.....	10,000.00
Capital Stock:	
Preferred—2,000 shares (par value \$50 each)	100,000.00
Common—5,000 shares (par value \$100 each)	500,000.00
Surplus.....	250,000.00
	<u>\$1,561,443.00</u>

On February 1, 1931, The Artex Company purchased \$50,000.00 par value of the First Mortgage Bonds of The Plymouth Machine Company at 80, and on July 1, 1931, it made another purchase of \$25,000.00 of these bonds at 75. A total of \$500,000.00 of these bonds was originally issued as of March 1, 1925, and sold to bankers at 92, interest payable semiannually on March 1 and September 1.

The balance sheets of the three companies on September 30, 1931, were as follows:

	Artex Company	Burnam Corpora- tion	Plymouth Machine Company
Assets			
Cash.....	\$ 1,000,000	\$ 182,800	\$ 100,000
Customers' Notes and Accounts....	2,500,000	700,000	200,000
Inventories.....	3,000,000	834,400	450,000
Advances to Subsidiaries.....	500,000	—	—
Investments:			
\$75,000.00 par value of Plymouth Machine Co. Bonds.....	58,750	—	—
Capital Stocks of Subsidiaries....	2,800,000	—	—
Land.....	400,000	125,000	65,000
Buildings.....	1,500,000	750,000	200,000
Machinery and Equipment.....	3,000,000	1,025,000	484,000
Discount on First Mortgage Bonds..	—	—	15,711
Prepaid Expenses.....	30,000	20,000	10,485
	\$14,788,750	\$3,637,200	\$1,525,196
Liabilities			
Notes and Accounts Payable.....	\$ 2,500,000	\$ 50,000	\$ 100,000
Federal Income Tax Payable.....	25,000	10,000	—
Accrued Interest:			
On First Mortgage Bonds.....	—	—	1,896
On Notes Payable.....	23,750	1,000	300
Other Accrued Expenses.....	40,000	1,200	500
Due to The Artex Company.....	—	250,000	250,000
Fifteen-Year 6½% First Mortgage Bonds.....	—	—	350,000
Reserve for Depreciation.....	1,500,000	450,000	160,000
Reserve for Uncollectible Accounts..	200,000	25,000	12,500
Capital Stock:			
Preferred.....	—	450,000	100,000
Common.....	7,500,000	1,500,000	500,000
Surplus.....	3,000,000	900,000	50,000
	\$14,788,750	\$3,637,200	\$1,525,196

There were 75,000 shares of capital stock of The Artex Company outstanding on September 30, 1931. There had been no change in the outstanding stocks of the other two companies during the previous five years.

Dividends on the preferred stocks of the subsidiaries were

cumulative, in both cases, at the rate of 7% per annum. In the case of The Burnam Corporation, the preferred dividends were payable quarterly on the first days of February, May, August, and November, and had been paid regularly since the organization of the company. Preferred dividends of The Plymouth Machine Company were payable semiannually on March 1 and September 1, and the last dividend paid was for the six months ended March 1, 1930. Prior to that time, they had never been in arrears. All preferred stocks are non-participating.

The Artex Company takes up interest on Plymouth Company bonds only when received.

Prepare a consolidated balance sheet as of September 30, 1931, showing the figures for the companies separately with eliminations and consolidation.

No goodwill is to be shown on the consolidated balance sheet. Show amounts to the nearest dollar.

QUESTIONS AND PROBLEMS ON CHAPTER 47

QUESTIONS

Question 47-1. Assume that a company had a capital stock of \$40,000.00 and a surplus of \$10,000.00. Additional stock of a par value of \$160,000.00 was issued to another company which had hitherto owned none of the stock. This company paid \$230,000.00 for the stock. State the amount of goodwill which would appear in the consolidated balance sheet and the amount of the minority interest.

Question 47-2. To what extent, if at all, will the method of making eliminations be affected by the fact that the holding company holds subsidiary stock of no-par value?

Question 47-3. On January 1, 1933, Company A acquires 90% of the stock of Company B and 80% of the stock of Company C. Included in Company C's inventory are goods produced by Company B at a cost of \$10,000.00 and billed to Company C at \$12,000.00. How should this condition be shown in a consolidated balance sheet prepared on January 1, 1933?

Question 47-4. Company X owns 90% of the stock of Company Y, and 85% of the stock of Company Z; X has owned this stock for several years. A consolidated balance sheet is to be prepared, on December 31, 1933, at which time there are goods in Company Z's inventory which were acquired from Company Y. The cost to Company Y was \$20,000.00, and the selling price to Company Z was \$25,000.00. How should this condition be dealt with?

Question 47-5. What difficulty exists in connection with the establishment of a reserve for intercompany profits in construction which does not exist in connection with intercompany profits in inventories?

PROBLEMS

Problem 47-1. Company A acquired \$75,000.00 (par value) of the capital stock of Company B in exchange for its own preferred stock of a par value of \$100,000.00. The surplus of Company B

at the date of acquisition was \$20,000.00. Balance sheets of the two companies on December 31, 1934, were as follows:

	Company A	Company B
Assets		
Cash.....	\$ 15,000.00	\$ 1,500.00
Accounts Receivable.....	80,000.00	15,000.00
Notes Receivable.....	95,000.00	
Advances to Company B.....	25,000.00	
Inventories.....	80,000.00	95,000.00
Investments:		
In Company B.....	100,000.00	
Miscellaneous.....	15,000.00	
Land and Buildings—Depreciated Value.....	70,000.00	
Store Fixtures—Depreciated Value.....	15,000.00	
Machinery and Equipment—Depreciated Value..		115,000.00
Prepaid Expenses.....	5,000.00	3,000.00
	<u>\$500,000.00</u>	<u>\$229,500.00</u>
Liabilities		
Accounts Payable.....	\$ 20,000.00	\$ 14,700.00
Notes Payable:		
Company B.....	20,000.00	
Banks.....	35,000.00	10,000.00
Trade Creditors.....		15,000.00
Accrued Liabilities.....	3,000.00	
Company A.....		25,000.00
Mortgage on Land and Buildings.....	30,000.00	
Capital Stock—\$100.00 Par Value:		
Preferred.....	300,000.00	
Common.....	50,000.00	80,000.00
Surplus.....	42,000.00	84,800.00
	<u>\$500,000.00</u>	<u>\$229,500.00</u>

Company B was contingently liable on December 31, 1934, on notes receivable discounted in the following amounts:

Notes of customers of Company B.....	\$15,000.00
Notes of Company A.....	20,000.00
Notes of customers of Company A, indorsed by Company A and transferred to Company B in payment of merchandise; rein-dorsed by Company B and discounted at bank.....	12,000.00

Dividends at the rate of 6% were declared by both companies on December 31, 1934, on all classes of stock; they have not been paid or recorded.

Inventories of Company A contain goods sold to it by Company B at a profit of \$8,000.00.

Prepare a consolidated balance sheet.

Problem 47-2. Following are the balance sheets of Companies M and N as of December 31, 1929:

COMPANY M

Balance Sheet

Assets

Current:			
Cash	\$	50,000	
Accounts Receivable—Customers		800,000	
Accounts Receivable—N Company		100,000	
Inventories		480,000	\$1,430,000
Fixed—Less Reserve for Depreciation			3,500,000
Investment in N Company (Cost of 3,800 shares of preferred and 23,520 shares of common, acquired July 1, 1929)			800,000
Prepaid Expenses			20,000
Goodwill			1,000,000
			<u>\$6,750,000</u>

Liabilities

Current:			
Notes Payable	\$	400,000	
Accounts Payable		200,000	
Dividends Payable		105,000	
Accruals		45,000	\$ 750,000
Funded Debt—First Mortgage Bonds			2,000,000
Capital Stock:			
Preferred—6%, cumulative, \$100.00 each	\$	1,000,000	
Common—30,000 shares, no-par value		2,500,000	3,500,000
Surplus			500,000
			<u>\$6,750,000</u>

COMPANY N

Balance Sheet

Assets

Current:			
Cash	\$	15,000	
Accounts Receivable—Customers		300,000	
Inventories		150,000	\$ 465,000
Fixed—Less Reserve for Depreciation			800,000
Prepaid Expenses			5,000
Goodwill			250,000
			<u>\$1,520,000</u>

Liabilities

Current:			
Notes Payable	\$	100,000	
Accounts Payable		150,000	
Dividends Payable		29,000	
Accruals		21,000	\$ 300,000
Funded Debt—Serial Gold Notes			400,000
Capital Stock:			
Preferred—4,000 shares, non-participating, no-par value; entitled to cumulative dividends of \$5.00 per share	\$	300,000	
Common—24,000 shares, no-par value		400,000	700,000
Surplus			120,000
			<u>\$1,520,000</u>

Particulars of the Surplus accounts of the respective companies are shown as follows:

COMPANY M

1929			
Jan. 1	Balance.....		\$345,250
Mar. 31	Preferred dividends, March quarter.....	\$ 15,000	
June 30	Net income for the half year.....		120,000
	Dividends—Preferred, June quarter.....	15,000	
	Dividends—Common, half year.....	90,000	
Sept. 30	Preferred dividends, September quarter.....	15,000	
Oct. 15	Dividend received on N Company preferred stock for quarter ended September 30th.		4,750
Dec. 31	Net income for the half year.....		270,000
	Dividends—Preferred, December quarter.....	15,000	
	Dividends—Common, half year.....	90,000	
	Balance.....	500,000	
		<u>\$740,000</u>	<u>\$740,000</u>

COMPANY N

1929			
Jan. 1	Balance.....		\$ 44,000
Mar. 31	Preferred dividend, March quarter.....	\$ 5,000	
June 30	Net loss for the half year.....	50,000	
	Preferred dividend, June quarter.....	5,000	
July 1	Increase on appraisal of fixed assets.....		90,000
Sept. 30	Preferred dividend, September quarter.....	5,000	
Dec. 31	Net income for the half year.....		80,000
	Dividends—Preferred, December quarter . . .	5,000	
	Dividends—Common.....	24,000	
	Balance.....	120,000	
		<u>\$214,000</u>	<u>\$214,000</u>

From the foregoing data, you are required to prepare a consolidated balance sheet as of December 31, 1929.

Problem 47-3. Following are the balance sheets of White Company and its two subsidiaries on December 31, 1934:

	White Company	Black Company	Green Company
Assets			
Cash.....	\$ 40,000	\$ 35,000	\$ 30,000
Inventories.....	325,000	190,000	133,000
Fin. Gds. on Consignment—at Selling Price.....			100,000
Accounts Receivable.....	160,000	70,000	25,000
Advances to Black Company.....	135,000		
Advances to Green Company.....	97,000		
Investment in Black Company.....	260,000		
Investment in Green Company.....	105,000		
Real Estate, Machinery, Etc.....	1,000,000	275,000	60,000
Goodwill.....	1,000,000	200,000	
	<u>\$3,122,000</u>	<u>\$770,000</u>	<u>\$348,000</u>

Liabilities and Net Worth			
Accounts Payable.....	\$ 77,000	\$105,000	\$81,000
Notes Payable.....	225,000	85,000	60,000
White Company.....		135,000	97,000
First Mortgage, 6%, Gold Bonds	500,000		
Capital Stock—Par Value \$100.00:			
Preferred, 7%, Cumulative.....	1,000,000		
Common.....	1,000,000	150,000	150,000
Surplus.....	320,000	295,000	40,000*
	<u>\$3,122,000</u>	<u>\$770,000</u>	<u>\$348,000</u>

* Deficit.

The consigned goods cost the Green Company \$70,000.00.

The investment in the Black Company represents the cost of a 95% interest, acquired when the Black Company had a surplus of \$240,000.00.

The investment in Green Company represents the cost of a 100% interest, acquired when the Green Company had a deficit of \$60,000.00.

The inventories of The White Company contain goods purchased from the Black Company and the Green Company, on which these subsidiaries made profits of \$12,000.00 and \$6,000.00, respectively.

Prepare a consolidated balance sheet as of December 31, 1934.

Problem 47-4. Prepare a consolidated balance sheet as of December 31, 1935, from the following individual balance sheets:

	<u>X</u>	<u>A</u>	<u>B</u>
Assets			
Cash.....	\$ 40,000.00	\$ 9,000.00	\$ 4,000.00
Accounts Receivable.....	8,000.00(a)	50,000.00	30,000.00
Notes Receivable.....		25,000.00(b)	20,000.00(c)
Inventory.....		40,000.00(d)	33,000.00(e)
Treasury Stock.....		12,000.00(f)	
800 Shares "A" Common..	145,000.00(g)		
200 Shares "B" Preferred..	15,000.00(g)		
700 Shares "B" Common..	50,000.00(g)		
Sinking Fund Investments.		6,000.00(h)	
Deficit.....			20,000.00(i)
Plant.....		75,000.00(j)	65,000.00
	<u>\$258,000 00</u>	<u>\$217,000.00</u>	<u>\$172,000.00</u>
Liabilities and Net Worth			
Accounts Payable.....	\$ —	\$ 5,000.00	\$ 16,000.00
Notes Payable.....	—	10,000.00	12,000.00
Bonds Payable.....	40,000.00(k)	50,000.00	40,000.00
Reserve for Depreciation...	—	5,000.00	4,000.00
Sinking Fund Reserve.....	—	6,000.00(l)	—
Premium on Bonds.....	8,000.00	—	—
Common Stock (Par \$100)..	200,000.00	100,000.00	75,000.00
Preferred Stock (Par \$100)..	—	—	25,000.00(m)
Surplus.....	10,000.00	41,000.00(n)	—
	<u>\$258,000.00</u>	<u>\$217,000.00</u>	<u>\$172,000.00</u>

- (a) Represents advances to *B*, which are placed on *B*'s books at only \$7,500.00, as the payment of *B*'s note for \$500.00 by *X* has not yet been recorded by *B*.
 (b) Includes *B*'s note for \$10,000.00.
 (c) Not including \$1,000.00 undue notes receivable discounted made by *A*, and \$500.00 made by an outside solvent firm.
 (d) Valued at cost to *A*; includes \$990.00 goods purchased from *B*, on which *B* made a profit of \$300.00.
 (e) Valued at selling price; gross profit on cost of sales, 10%.
 (f) 100 shares purchased January 1, 1935, on open market.
 (g) Purchased January 1, 1935, on open market.
 (h) Represents five \$1,000.00 bonds purchased from *X* on July 1, 1935.
 (i) Balance January 1, 1935, was \$11,000.00.
 (j) Includes \$26,000.00 plant addition made by *B* at end of 1935 at cost of \$20,000.00.
 (k) Issued July 1, 1935, at 120; due July 1, 1955.
 (l) Created July 1, 1935.
 (m) Cumulative 7% dividend for year, undeclared. Stock is preferred as to assets.
 (n) Balance, January 1, 1935, was \$18,000.00.

Problem 47-5. Company *P* obtained controlling interests in three companies, *A*, *B*, and *C*, on January 1, 1933. The balance sheets of the four companies on December 31, 1933, were as follows:

	Company <i>P</i>	Company <i>A</i>	Company <i>B</i>	Company <i>C</i>
Assets				
Cash.....	\$ 50,000	\$ 75,000	\$ 15,000	\$ 60,000
Accounts Receivable.....		120,000	55,000	95,000
Company <i>A</i>	100,000			
Company <i>C</i>	50,000			
Inventories.....		225,000	130,000	75,000
Fixed Assets.....		985,000	615,000	425,000
Investments in Subsidiaries:				
Company <i>A</i> —70%.....	950,000			
Company <i>B</i> —80%.....	650,000			
Company <i>C</i> —90%.....	500,000			
	<u>\$2,300,000</u>	<u>\$1,405,000</u>	<u>\$815,000</u>	<u>\$655,000</u>
Liabilities				
Accounts Payable.....	\$ 40,000	\$ 30,000	\$ 55,000	\$ 65,000
Company <i>P</i>		100,000		50,000
Capital Stock.....	2,000,000	1,000,000	800,000	400,000
Surplus.....	260,000	275,000	40,000*	140,000
	<u>\$2,300,000</u>	<u>\$1,405,000</u>	<u>\$815,000</u>	<u>\$655,000</u>

The Surplus accounts of the four companies for 1933 are detailed below:

Balance, December 31, 1932.....	\$266,400	\$190,000	\$90,000*	\$120,000
Net Profit—1933.....		145,000	50,000	44,000
Dividends Received.....	63,600			
Write-Up Stock of Company <i>A</i>	50,000			
Total.....	<u>\$380,000</u>	<u>\$335,000</u>	<u>\$40,000*</u>	<u>\$164,000</u>
Dividends Paid.....	120,000	60,000		24,000
Balance—December 31, 1933.....	<u>\$260,000</u>	<u>\$275,000</u>	<u>\$40,000*</u>	<u>\$140,000</u>

The inventories of Company *A* include \$100,000.00 of goods purchased from Company *B* in 1933. The cost to Company *B*

was \$80,000.00.

Part of the plant of Company *B* was purchased from Company *C* on December 31, 1933. The depreciated value of this property on *C*'s books was \$100,000.00, and the sale price to Company *B* was \$110,000.00.

On December 28, 1933, part of Company *C*'s plant, carried at \$20,000.00, was destroyed by fire. The property account was credited with the salvage of \$5,000.00, and no other entries were made, pending the insurance settlement. The claim was settled in 1934 for \$12,500.00.

Prepare a consolidated balance sheet.

QUESTIONS AND PROBLEMS ON CHAPTER 48

QUESTIONS

Question 48-1. Assume that, at the date of preparing the consolidated balance sheet, the subsidiary has a deficit. Should the minority interest be shown at the par value of the stock or at the par value minus a portion of the deficit?

Question 48-2. Assume that a subsidiary issues a stock dividend. State how you would record the stock dividend, if at all, on the parent company's books, under the following conditions, and give your reasons:

- (a) The parent company carries its investment at cost.
- (b) The parent company takes up the subsidiary profits, losses, and cash dividends.

Question 48-3. A parent company owns the stock of a subsidiary company, for the purchase of which it issued two shares of its own stock for each share of the subsidiary company's stock. The assets of the subsidiary company were sold, and after the debts of such subsidiary company were liquidated, the remaining balance was paid in cash to the parent company. How should the cash so received be treated on the books of the parent company?

Question 48-4. If, in consolidating the accounts of a parent company and its subsidiary companies, you found that, in the case of one of the subsidiary companies, the parent company owned only 60% of its voting stock, state briefly how you would treat this subsidiary company account in the consolidated balance sheet, and why your proposed treatment would reflect the true financial position of the combined companies more clearly than other methods with which you may be familiar.

Question 48-5. On July 1, 1933, Corporation *A* received an option to purchase all of the assets of Corporation *B* for \$1,000,000.00, payable \$50,000.00 upon the date of the option and \$50,000.00 semiannually thereafter until the expiration date, July 1, 1935, when the balance will be due. The assets appear at a value of \$800,000.00 in the accounts of Corporation *B*. If the option is

not taken up on or before the expiration date, the payments made are forfeited to Corporation B. Corporation B had no surplus on June 30, 1933, all of its income having been distributed. Subsequent to July 1, 1933, all its income, together with the money received from Corporation A, was paid out in dividends. You are auditing the accounts of Corporation C, which is a stockholder in Corporation B and has received dividends from that company, which have been credited to Profit and Loss. State whether you would accept the entries on the books of Corporation C, and if you would not, state how you would advise that the matter be handled.

PROBLEMS

Problem 48-1. Following is the balance sheet of The Washburn Company on December 31, 1934:

THE WASHBURN COMPANY		
Balance Sheet—December 31, 1934		
Assets		
Current Assets:		
Accounts Receivable.....	\$ 25,000	
Inventory.....	200,000	\$ 225,000
Intercompany Accounts:		
The Midland Company....	\$ 75,000	
The Blackthorn Company.....	20,000	95,000
Investments:		
\$50,000 in The Blackthorn Company Bonds.....	\$ 50,000	
150 Shares in The Blackthorn Company.....	25,000	
800 Shares in The Midland Company (Preferred)....	80,000	
2,000 Shares in The Midland Company (Common)....	375,000	530,000
Fixed Assets.....		900,000
Deferred Charges to Operation.....		15,000
		<u>\$1,765,000</u>
Liabilities		
Current Liabilities:		
Accounts Payable.....	\$ 70,000	
Bond Interest Accrued.....	10,000	\$ 80,000
First Mortgage 6% Bonds.....		500,000
Reserve for Depreciation.....		300,000
Capital Stock—Total Authorized and Issued:		
5,000 Shares of \$100.00 Each.....		500,000
Surplus:		
Balance, December 31, 1933.....	\$225,000	
Profit for the Year 1934.....	160,000	385,000
		<u>\$1,765,000</u>

All of the investments included in the foregoing balance sheet were acquired on January 1, 1934, and are stated at cost, except that \$75,000.00 has been added to the book value of the common stock

of The Midland Company by a credit to Profit and Loss.

THE BLACKTHORN COMPANY
Balance Sheet—December 31, 1934

Assets		
Current Assets:		
Accounts Receivable.....	\$18,000.00	
Inventory.....	<u>62,000.00</u>	\$ 80,000.00
Investments:		
100 Shares in The Midland Company (Preferred)—Cost.....		10,000.00
Fixed Assets.....		150,000.00
Deferred Charges.....		<u>10,000.00</u>
		<u>\$250,000.00</u>
Liabilities		
Current Liabilities:		
Accounts Payable.....	\$14,500.00	
Bond Interest Accrued.....	<u>500.00</u>	\$ 15,000.00
Intercompany Accounts:		
The Washburn Company.....	\$20,000.00	
The Midland Company.....	<u>15,000.00</u>	35,000.00
First Mortgage 6% Bonds.....		50,000.00
Reserve for Depreciation.....		15,000.00
Capital Stock—Total Authorized and Issued:		
750 Shares at \$100.00 Each.....		75,000.00
Surplus:		
Balance, December 31, 1933.....	\$30,000.00	
Profit for the Year 1934.....	<u>30,000.00</u>	60,000.00
		<u>\$250,000.00</u>

Following is the balance sheet of The Midland Company. The stock of The Blackthorn Company, shown therein at cost, was acquired at the date of organization of the latter-named company. The Midland Company's preferred stock is preferred as to assets and as to 6% cumulative dividends. No dividends were in arrears at the dates of acquisition of this stock by the other companies, nor on December 31, 1934.

THE MIDLAND COMPANY
Balance Sheet—December 31, 1934

Assets		
Current Assets:		
Accounts Receivable.....	\$ 56,000.00	
Inventory.....	<u>74,000.00</u>	\$130,000.00
Intercompany Accounts:		
The Blackthorn Company.....		15,000.00
Investments:		
500 Shares in The Blackthorn Company—Cost.....		50,000.00
Fixed Assets.....		540,000.00
Deferred Charges to Operations.....		<u>19,950.00</u>
		<u>\$754,950.00</u>

Liabilities	
Current Liabilities:	
Accounts Payable.....	\$ 30,500.00
Bond Interest Accrued	1,500.00
Preferred Dividend, Payable January 1, 1935...	<u>3,000.00</u>
	\$ 35,000.00
Intercompany Accounts:	
The Washburn Company	75,000.00
First Mortgage 6% Bonds.....	150,000.00
Reserve for Depreciation.....	20,000.00
Capital Stock—Total Authorized and Issued:	
Preferred, 1,000 Shares.....	\$100,000.00
Common, 2,500 Shares.....	<u>250,000.00</u>
	350,000.00
Surplus:	
Balance, December 31, 1933.....	\$ 75,000.00
Profit for the Year 1934.....	<u>49,950.00</u>
	<u>124,950.00</u>
	<u>\$754,950.00</u>

Prepare a consolidated balance sheet.

Problem 48-2. On December 31, 1930, Company A had \$500,000.00 of outstanding stock and a surplus of \$115,000.00. Company B had 10,000 shares of authorized stock, of \$100.00 par value, of which 8,000 shares were outstanding; and a surplus of \$48,000.00 after the declaration of a 6% dividend, payable February 1, 1931, to holders of record, January 15, 1931.

Company A, on December 31, 1930, purchased 90% of the outstanding stock of Company B at 120 per share; the purchase was registered on Company B's books on January 10, 1931.

The profits of the two companies for the six months ended June 30, 1931 were: Company A, \$30,000.00; Company B, \$24,000.00.

On July 1, 1931, the directors of Company B authorized the sale of the unissued stock at a price equal to the book value of the stock then outstanding, after the declaration of a 4% dividend payable July 15, the stockholders on July 1 having the right to subscribe in proportion to their holdings on that date. All of the stock was accordingly issued for cash on July 1.

The profits of the two companies for the six months ended December 31, 1931 were: Company A, \$35,000.00; Company B, \$30,000.00.

In addition to the above-stated profits, Company A took up its share of the profits of Company B as of June 30 and December 31, 1931, and charged Dividends Receivable with all dividends declared by Company B.

Each company declared dividends on December 31, 1931, as follows: Company A, 6%; Company B, 4%.

(a) Prepare a statement of the following accounts:

Company A's books: Investment in Company B; Surplus
Company B's books: Capital Stock; Surplus

- (b) Consolidated balance sheets were prepared on December 31, 1930; June 30, 1931; July 1, 1931, after issuance of additional stock by Company *B*; and December 31, 1931. What amounts should appear in each of these consolidated balance sheets for Goodwill, Minority Interest, and Consolidated Surplus?

Problem 48-3. Prepare a consolidated balance sheet as of December 31, 1934, from the following data, assuming that there were no Surplus or Deficit accounts at the dates when the inter-company stockholdings were acquired, and that the stock investments are carried at cost.

Balance Sheets—December 31, 1934			
	Company <i>A</i>	Company <i>B</i>	Company <i>C</i>
Assets.....	\$100,000.00	\$50,000.00	\$50,000.00
Investments in <i>B</i> :			
90%.....	23,000.00		
5%.....			1,500.00
Investments in <i>C</i> :			
85%.....	22,000.00		
10%.....		2,700.00	
Deficit.....		12,250.00	
	<u>\$145,000.00</u>	<u>\$64,950.00</u>	<u>\$51,500.00</u>
Liabilities.....	\$ 50,000.00	\$39,950.00	\$10,000.00
Capital Stock	75,000.00	25,000.00	25,000.00
Surplus.....	20,000.00		16,500.00
	<u>\$145,000.00</u>	<u>\$64,950.00</u>	<u>\$51,500.00</u>

Problem 48-4. Company *A*, by a series of purchases, acquired 95% of the stock of Company *B*, as follows:

Date	Per Cent	Cost
Jan. 1, 1932	55%	\$170,000.00
May 1, 1932	15	85,000.00
Oct. 1, 1933	25	140,000.00
Total	<u>95%</u>	<u>\$395,000.00</u>

The Surplus account of Company *B* appears as follows:

Balance—Jan. 1, 1932.....	\$ 45,000.00
Profits—1932.....	120,000.00
Dividends—April 1, 1932.....	\$ 16,000.00
Dividends—November 1, 1932.....	16,000.00
Profits—1933.....	90,000.00
Dividends—June 1, 1933.....	30,000.00
Balance—December 31, 1933.....	193,000.00
	<u>\$255,000.00</u> <u>\$255,000.00</u>

It may be assumed that the profits were earned in equal monthly proportions in the respective years.

The balance sheets of the two companies on December 31, 1933, are summarized below:

	<u>Company A</u>	<u>Company B</u>
Current Assets.....	\$ 475,000.00	\$250,000.00
Fixed Assets.....	510,000.00	190,000.00
Investment in Company B.....	395,000.00	
	<u>\$1,380,000.00</u>	<u>\$440,000.00</u>
Current Liabilities.....	\$ 230,000.00	\$ 47,000.00
Capital Stock.....	1,000,000.00	200,000.00
Surplus.....	150,000.00	193,000.00
	<u>\$1,380,000.00</u>	<u>\$440,000.00</u>

Prepare a consolidated balance sheet as of December 31, 1933.

Problem 48-5. Company *P* acquired 90% of the stock of Company *Y* and 80% of the stock of Company *Z*, on January 1, 1934. On March 31, Company *P* sold 100 shares of Company *Y* stock at \$200.00 per share. On September 30, Company *P* purchased 100 shares of Company *Z* at \$150.00. The Investment accounts have been charged with the cost of stock purchased, and credited with the proceeds of stock sold. No other entries have been made therein. The balance sheets of the three companies on December 31, 1934, were as follows:

	<u>Com- pany P</u>	<u>Com- pany Y</u>	<u>Com- pany Z</u>
Assets			
Cash.....	\$ 15,000	\$ 18,000	\$ 8,000
Accounts Receivable.....	45,000	51,000	35,000
Inventories.....	54,000	63,000	52,000
Fixed Assets—Less Depreciation.....	97,000	90,000	80,000
Investment in Company Y.....	115,000		
Investment in Company Z.....	105,000		
Current Accounts.....	60,000		
	<u>\$491,000</u>	<u>\$222,000</u>	<u>\$175,000</u>
Liabilities and Net Worth			
Accounts Payable.....	\$127,000	\$ 62,000	\$ 20,000
Current Accounts.....		25,000	35,000
Capital Stock:			
Company P—3,000 Shares.....	300,000		
Company Y—1,000 Shares.....		100,000	
Company Z—1,000 Shares.....			100,000
Surplus.....	64,000	35,000	20,000
	<u>\$491,000</u>	<u>\$222,000</u>	<u>\$175,000</u>

The Surplus accounts of the three companies are analyzed as follows:

PROBLEMS ON CHAPTER 48

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	<u>Company P</u>	<u>Company Y</u>	<u>Company Z</u>
Balances, December 31, 1933.....	\$50,000.00	\$30,000.00	\$10,000.00
Profits—1934			
First Quarter.....	3,000.00	10,000.00	6,000.00
Second Quarter.....	1,000.00	12,000.00	8,000.00
Third Quarter.....	16,500.00*	15,000.00	14,000.00
Fourth Quarter.	2,000.00	8,000.00	7,000.00
Dividends Paid—December 31....	30,000.00*	40,000.00*	25,000.00*
Dividends from Company Y. . . .	32,000.00		
Dividends from Company Z.....	22,500.00		
Balances, December 31, 1934.....	<u>\$64,000.00</u>	<u>\$35,000.00</u>	<u>\$20,000.00</u>

* Debits.

Prepare a consolidated balance sheet as of December 31, 1934.

QUESTIONS AND PROBLEMS ON CHAPTER 49

QUESTIONS

Question 49-1. Company *P* has owned 90% of the stock of Company *S* for several years, and has taken up its share of the subsidiary's profits, losses, and dividends. Its accounts contain the following balances on December 31, 1934:

Investment in Stock of Company <i>S</i>	\$130,000.00	
Company <i>S</i> Profit—1934		\$ 13,500.00

Company *S* has \$100,000.00 of capital stock outstanding; it had a surplus of \$25,000.00 at the beginning of 1933; it made a profit of \$15,000.00 during 1934, and paid no dividend during that year. Give the journal entry to be applied in the working papers at the end of 1934, to eliminate the parent company's portion of the capital stock and surplus of the subsidiary. What amounts should appear as goodwill and as minority interest in the consolidated balance sheet?

Question 49-2. Company *P* owns 85% of the stock of Company *S*, which was purchased several years ago. The accounts of Company *P*, on December 31, 1934, contain the following balances:

Investment in Stock of Company <i>S</i>	\$125,000.00	
Company <i>S</i> Profit—1934		\$ 8,500.00

The accounts of Company *S* contain the following balances:

Capital Stock	\$100,000.00	
Surplus—December 31, 1933		40,000.00
Dividends Paid—1934	\$ 6,000.00	

Give the journal entry to be applied in the working papers to eliminate the parent company's portion of the capital stock and surplus of the subsidiary. What amounts should appear as goodwill and as minority interest in the consolidated balance sheet?

Question 49-3. Company *P* has owned 90% of the \$100,000.00 of outstanding stock of Company *S* for several years; Company *S* had a deficit of \$5,000.00 at the date of the stock acquisition. The investment is carried on the books of the parent company at cost, \$88,000.00.

Company *S* had a surplus of \$20,000.00 on December 31, 1933, and made a profit of \$5,000.00 during 1934; no dividends were paid by Company *S* during 1934.

Give the adjusting journal entry to be applied in the working papers to take up the parent company's percentage of the increase in the subsidiary surplus since acquisition, and the entries to eliminate the parent company's percentage of the capital stock and surplus of the subsidiary on December 31, 1934. State the amount of the goodwill and the amount of the minority interest.

Question 49-4. Company *P* has owned 80% of the \$100,000.00 of outstanding stock of Company *S* for several years, and is carrying the investment at cost. At the end of 1934, Company *P*'s accounts contain the following balances:

Investment in Stock of Company <i>S</i> ..	\$100,000.00	
Dividends Received—Company <i>S</i> ..		\$ 4,800.00

Company *S* had a surplus of \$12,000.00 at the date of acquisition, and a surplus of \$4,000.00 on December 31, 1933. Company *S* lost \$5,000.00 and paid a \$6,000.00 dividend during 1934. Give the adjusting journal entry to take up the parent company's share of the change in subsidiary surplus since the date of acquisition, and the entries to eliminate the parent company's percentage of the capital stock and surplus of the subsidiary. State the amounts of the goodwill and the minority interest.

PROBLEMS

Problem 49-1. The Roosevelt Company owns 88% of the stock of the Penny Company, and takes up its share of the subsidiary's profits, losses, and dividends through its Investment account.

Trial balances of the two companies on December 31, 1933, appear below:

<u>Debits</u>	<u>Roosevelt Company</u>	<u>Penny Company</u>
Cash.....	\$ 44,800.00	\$ 3,950.00
Accounts Receivable.....	130,500.00	66,110.00
Penny Company.....	31,850.00	
Inventory, December 31, 1933..	59,600.00	51,150.00
Land and Buildings.....	146,500.00	
Machinery and Equipment.....	85,100.00	103,500.00
Goodwill.....	39,750.00	
Investment in Penny Company:		
Stock.....	59,210.00	
Bonds—purchased at par.....	12,500.00	
Sinking Fund Trustee.....		5,000.00
Cost of Sales.....	571,170.00	213,660.00

Selling Expenses	\$ 95,190.00	\$ 31,150.00
General Expenses	64,500.00	21,000.00
Interest Expense	9,100.00	6,350.00
Loss of Penny Company	3,960.00	
Dividends Paid	20,000.00	3,000.00
	<u>\$1,373,730.00</u>	<u>\$504,870.00</u>

Credits

Accounts Payable	\$ 63,160.00	60,760.00
Roosevelt Company		14,350.00
Reserve for Depreciation	86,100.00	23,500.00
Bonds Payable	150,000.00	60,000.00
Preferred Stock	100,000.00	
Common Stock	140,000.00	100,000.00
Surplus, January 1, 1933	29,870.00	21,400.00*
Sales	804,600.00	267,660.00
	<u>\$1,373,730.00</u>	<u>\$504,870.00</u>

* Debit.

The \$17,500.00 difference in the intercompany accounts results from the following debits on the books of the Roosevelt Company:

December 31—Sinking fund deposit made for Penny Company on guaranteed bonds of the latter	\$ 5,000.00
December 31—Sale to Penny Company, not received by Penny until 1934 (cost \$9,800.00)	12,500.00
Total	<u>\$17,500.00</u>

Prepare consolidated working papers and statements.

Problem 49-2. The Padway Company acquired 75% of the stock of the Stork Company at 124 on January 1, 1933, and an additional 20% at 126½ on June 30, 1933. The trial balances of the two companies on December 31, 1933, appear as follows:

<u>Debits</u>	<u>Padway Company</u>	<u>Stork Company</u>
Cash	\$ 11,800	\$ 40,500
Accounts Receivable	61,100	35,000
Notes Receivable	85,000	14,500
Inventory, January 1, 1933	39,200	29,500
Investment in Stork Company	55,400	
Furniture and Fixtures	16,000	8,700
Purchases	315,700	171,100
Freight In	16,400	11,000
Returned Sales	34,100	12,200
Wages	54,500	34,100
General Expenses	28,000	21,100
Bad Debts	3,500	2,600
Depreciation		900
Interest Paid	2,100	1,000
Dividends Paid (May 1933)		5,000
	<u>\$722,800</u>	<u>\$387,200</u>

<u>Credits</u>		
Accounts Payable.....	\$ 16,700	\$ 21,100
Notes Payable.....	25,000	
Notes Pay.—Padway Co.—Due January 1, 1934		30,000
Notes Receivable Discounted.....	30,000(2)	10,000(1)
Reserve for Bad Debts.....	3,000	2,100
Reserve for Depreciation.....	7,100	4,000
Capital Stock, \$100.00 par.....	100,000	50,000
Surplus, January 1, 1933.....	29,100	3,100
Sales.....	510,900	266,900
Interest Earned on Stork Company Notes Paid During the Year.....	1,000	
	<u>\$722,800</u>	<u>\$387,200</u>
Inventories, December 31, 1933.....	\$ 42,500	\$ 25,000

(1) Discounted with the Padway Company.

(2) The note payable of the Stork Company, discounted the day received.

Accrued interest on intercompany note, not set up by either company, \$400.00.

Padway Company recorded no depreciation for the year; rate, 10%.

Assuming that the Stork Company profit has been earned evenly through the year, prepare consolidated working papers, statement of profit and loss, statement of surplus, and balance sheet.

Problem 49-3. On December 31, 1934, the trial balances of Company A and its subsidiaries are as follows:

<u>Debits</u>	<u>Company A</u>	<u>Company B</u>	<u>Company C</u>
Cash.....	\$ 50,200	\$ 48,800	\$ 40,000
Notes Receivable.....	175,000	40,000	55,000
Accounts Receivable.....	200,000	290,000	300,000
Raw Material Inv., January 1, 1934....	100,000	55,000	110,000
Goods in Process Inv., January 1, 1934..	62,000	50,000	58,000
Finished Goods Inv., January 1, 1934...	85,000	90,000	75,000
Plant and Equipment.....	880,000	360,000	390,000
Purchases—Raw Materials.....	550,000	380,000	450,000
Labor.....	380,000	350,000	370,000
Expenses—Manufacturing.....	190,000	175,000	185,000
Expenses—Selling.....	70,000	60,000	65,000
Expenses—Administrative.....	30,000	35,000	40,000
Investment—Subsidiary Companies....	1,980,000		
	<u>\$4,752,200</u>	<u>\$1,933,800</u>	<u>\$2,138,000</u>
<u>Credits</u>			
Notes Payable.....	\$ 50,000	\$ 60,000	\$ 75,000
Accounts Payable.....	85,000	55,000	110,000
Bonds Payable 6's—1939.....	300,000		
Reserve for Depreciation.....	93,000	40,000	80,000
Capital Stock.....	2,000,000	580,000	500,000
Surplus.....	1,004,200	48,800	163,000
Sales.....	1,200,000	1,150,000	1,210,000
Service Charges.....	20,000		
	<u>\$4,752,200</u>	<u>\$1,933,800</u>	<u>\$2,138,000</u>

Companies *B* and *C* are owned outright by Company *A*, which paid \$750,000.00 for Company *B* and \$1,230,000.00 for Company *C* on January 1, 1934. Dividends of 10% were paid by each of the three companies; these dividend entries are the only Surplus entries during the year. Company *A* credited its Surplus for dividends received from Companies *B* and *C*.

The service charges taken as income by Company *A* are included in the manufacturing expenses of Companies *B* and *C*.

The inventories at December 31, 1934, are as follows:

	Company <i>A</i>	Company <i>B</i>	Company <i>C</i>
Raw Materials	\$200,200 00	\$60,900.00	\$90,800.00
Goods in Process	88,000 00	45,150.00	50,000.00
Finished Goods	77,000.00	73,500.00	80,600.00

The bonds payable were issued July 1, 1934, and the first semiannual interest payment is due January 1, 1935.

In Company *B*'s accounts payable is the sum of \$8,000.00 due to Company *A*, and the sum of \$4,000.00 due to Company *C*.

Prepare the following consolidated statement working papers: cost of goods sold; profit and loss; surplus; balance sheet.

Problem 49-4. The annual report of the Gladiator Corporation for 1933 contains the following statements:

Balance Sheet—December 31, 1933

Assets	
Cash	\$ 395,000.00
U. S. Government Securities	890,000.00
Investment in Valor Company—80%	705,000.00
Advances to Valor Company	150,000 00
	<u>\$2,140,000.00</u>
Liabilities and Net Worth	
Collateral Trust Bonds	\$ 500,000 00
Capital Stock	1,000,000.00
Surplus	640,000.00
	<u>\$2,140,000.00</u>

**Statement of Profit and Loss and Surplus
Year Ended December 31, 1933**

Profits of Valor Company (Estimated)	\$220,000.00	
Less Minority Interest—20%	44,000.00	\$ 176,000.00
Interest Earned		57,000.00
Dividends Received:		
Cash		20,000.00
Stock		40,000.00
Total		<u>\$ 293,000.00</u>
Expenses		<u>211,000.00</u>
Consolidated Net Profit		<u>\$ 82,000.00</u>

Consolidated Net Profit (Brought forward).....	\$	82,000.00
Dividends Paid.....		<u>70,000.00</u>
Increase in Surplus.....	\$	12,000.00
Surplus, January 1, 1933.....		628,000.00
Surplus, December 31, 1933.....	\$	<u>640,000.00</u>

The president's letter in the report contained the following statement: "In past years the investment in Valor Company has been carried at cost, and income taken up only as dividends have been received. However, with the purchase of an additional 25% interest on January 1, 1933, we have adopted the policy of taking up a proper share of Valor profits as soon as they are earned. The Valor dividends were taken into income because they represented distributions out of past surplus; future dividends will not appear in the income account. The stock dividend has conservatively been taken into income at par, although its book value is considerably in excess of par."

The general ledger trial balance of Valor Company on December 31, 1933, appears as follows:

Cash	\$	38,000.00	
Inventories.....		290,000.00	
Fixed Assets—Net.....		245,000.00	
Goodwill.....		80,000.00	
Accounts Payable—Gladiator Corporation....			\$ 143,000.00
Capital Stock—\$100.00 par			350,000.00
Surplus.....		65,000.00	
Sales.....			980,000.00
Cost of Sales.....		415,000.00	
Expenses.....		340,000.00	
		<u>\$1,473,000.00</u>	<u>\$1,473,000.00</u>

An analysis of the Surplus account reveals the following:

Surplus, January 1, 1933.....		\$120,000
Less:		
Discount on Sale of Stock to Gladiator Corporation—		
750 shares at \$20.00.....	\$15,000	
Cash Dividend.....	25,000	
Stock Dividend.....	50,000	
Provision to Reduce Inventories December 31, 1933, from		
cost to market.....	<u>95,000</u>	<u>185,000</u>
Deficit, December 31, 1933.....		<u>\$ 65,000</u>

You learn that the Valor Company has failed to take up \$7,000.00 of interest charged to it by the Gladiator Corporation for the year 1933, and also that the original holding of Valor stock had been acquired by the Gladiator Corporation at book value.

Prepare consolidated statements.

QUESTIONS AND PROBLEMS ON CHAPTER 50

QUESTIONS

Question 50-1. Company X acquired 90% of the stock of Company Y on January 1, 1932, and 80% of the stock of Company Z on January 1, 1933. The inventories of the three companies on December 31, 1932, contained goods purchased from other companies in the group, on which profits had been made as follows:

	PROFIT MADE BY		
	Company X	Company Y	Company Z
On goods in inventory of:			
Company X.....		\$1,500.00	\$1,200.00
Company Y.....	\$1,000.00		400.00
Company Z.....	2,000.00	1,800.00	
Totals.....	\$3,000.00	\$3,300.00	\$1,600.00

What adjustments should be made for intercompany profits in inventories in the consolidated working papers for the year ended December 31, 1933?

Question 50-2. Continuing the preceding question, the intercompany profits in inventories on December 31, 1933, were:

	PROFIT MADE BY		
	Company X	Company Y	Company Z
On goods in inventory of:			
Company X.....		\$1,900.00	\$1,500.00
Company Y.....	\$1,200.00		900.00
Company Z.....	2,500.00	2,000.00	
Totals.....	\$3,700.00	\$3,900.00	\$2,400.00

What adjustments should be made for intercompany profits in inventories in the consolidated working papers for the year ended December 31, 1933?

Question 50-3. Referring to the two preceding questions, what effect will the two adjustments have upon the consolidated net income for the year 1933?

Question 50-4. Company A has owned all of the stock of Company B for several years. On December 31, 1933, Company A

sold Company *B* certain real estate, as follows:

	Cost to Company <i>A</i>	Selling Price to Company <i>B</i>
Land.....	\$ 20,000.00	\$ 30,000.00
Building.....	100,000.00	120,000.00
Total.....	<u>\$120,000.00</u>	<u>\$150,000.00</u>

What reserve for intercompany profit in fixed assets should be created in the consolidated balance sheet of December 31, 1933?

Question 50-5. Continuing the preceding question, during 1934 Company *B* provided depreciation on the building at the rate of 5% on cost (\$120,000.00). What adjustment of the consolidated income for 1934 is required, and what reserve for intercompany profit should appear in the consolidated balance sheet as of December 31, 1934?

PROBLEMS

Problem 50-1. The following statements are prepared on December 31, 1934:

Profit and Loss Statement Year Ended December 31, 1934

	Company <i>N</i>	Company <i>O</i>
Sales.....	\$400,000.00	\$320,000.00
Less Cost of Sales:		
Inventory, January 1, 1934.....	\$ 60,000.00	\$ 40,000.00
Purchases.....	250,000.00	225,000.00
Total.....	<u>\$310,000.00</u>	<u>\$265,000.00</u>
Less Inventory, December 31, 1934.....	60,000.00	25,000.00
Remainder—Cost of Sales.....	<u>\$250,000.00</u>	<u>\$240,000.00</u>
Gross Profit on Sales.....	\$150,000.00	\$ 80,000.00
Less Expenses.....	120,000.00	75,000.00
Net Profit on Sales.....	\$ 30,000.00	\$ 5,000.00
Other Income.....	5,000.00	—
Net Profit.....	<u>\$ 35,000.00</u>	<u>\$ 5,000.00</u>

Balance Sheet—December 31, 1934

	Company <i>N</i>	Company <i>O</i>
Assets		
Cash.....	\$ 20,000.00	\$ 15,000.00
Accounts Receivable.....	55,000.00	25,000.00
Company <i>O</i>	10,000.00	
Inventory.....	60,000.00	25,000.00
Investment in Company <i>O</i> —85%.....	65,000.00	
Land and Buildings—Depreciated Value.....	55,000.00	30,000.00
	<u>\$265,000.00</u>	<u>\$ 95,000.00</u>

	Liabilities	
Accounts Payable.....	\$ 35,000 00	\$ 10,000.00
Company N.....		10,000.00
Capital Stock.....	100,000 00	50,000.00
Surplus.....	130,000.00	25,000.00
	<u>\$265,000.00</u>	<u>\$ 95,000.00</u>

Company O has sold merchandise to Company N during the past two years, as follows: \$50,000.00 during 1934, and \$60,000.00 during 1933. The rate of profit during the two years was the same. The amount of merchandise in Company N's inventory at the beginning and the end of 1934, at prices as billed by Company O, was \$25,000.00 and \$35,000.00, respectively.

The "Other Income" in Company N's statement represents a charge to Company O for administration, which has been debited by Company O to Expense.

Following is an analysis of the Surplus accounts of the two companies:

	Company N	Company O
Balance, January 1, 1933.....	\$ 47,250.00	\$ 5,000.00
Profits, 1933 (Including Dividends) ..	62,625.00	27,500.00
Total.....	<u>\$109,875.00</u>	<u>\$32,500.00</u>
Dividends Paid.....	7,000.00	10,000.00
Balance, December 31, 1933.....	<u>\$102,875.00</u>	<u>\$22,500.00</u>
Profits, 1934 (Including Dividends) ..	37,125.00	5,000.00
Total.....	<u>\$140,000.00</u>	<u>\$27,500.00</u>
Dividends Paid.....	10,000.00	2,500.00
Balance, December 31, 1934.....	<u>\$130,000.00</u>	<u>\$25,000.00</u>

Prepare working papers and consolidated profit and loss statement, surplus statement, and balance sheet, under each of the following conditions:

- (a) Stock was acquired on January 1, 1934.
- (b) Stock was acquired on January 1, 1933.

The parent company carries the investment at cost.

Problem 50-2. The trial balances of three affiliated companies on December 31, 1933, before closing, were as follows:

Debits	A	B	C
Cash.....	\$ 62,030.00	\$ 95,858.00	\$ 80,040.00
Notes Receivable.....	80,000.00		
Accounts Receivable.....	165,640.00	160,400.00	124,200.00
Raw Materials, January 1..	48,285.00	36,648.00	44,614.00
Goods in Process, January 1	49,625.00	47,600.00	54,717.00
Finished Goods, January 1.	43,650.00	43,819.00	47,480.00

Debits	<u>A</u>	<u>B</u>	<u>C</u>
Investments, at cost:			
Company B—100%	660,000.00		
Company C— 90%	650,000.00		
Sinking Fund Trustees	25,000.00		
Plant and Equipment	872,000.00	575,000.00	600,490.00
Discount on Bonds	14,250.00		
Purchases	395,850.00	243,380.00	260,690.00
Labor	225,610.00	175,829.00	195,713.00
Manufacturing Expense	258,450.00	184,372.00	160,440.00
Selling Expenses	99,480.00	75,210.00	82,814.00
General Expenses	92,250.00	49,394.00	54,982.00
Bond Interest	35,000.00		
	<u>\$3,777,120.00</u>	<u>\$1,687,510.00</u>	<u>\$1,706,180.00</u>
Credits			
Notes Payable	\$ 50,000.00	\$ 80,000.00	
Accounts Payable	54,705.00	49,610.00	\$ 57,615.00
First Mortgage Bonds	500,000.00		
Reserve for Depreciation	207,585.00	170,000.00	260,600.00
Capital Stock—\$100.00 par	1,500,000.00	500,000.00	500,000.00
Surplus, January 1	208,615.00	107,000.00	135,000.00
Sinking Fund Reserve	25,000.00		
Sales	1,231,215.00	780,900.00	752,965.00
	<u>\$3,777,120.00</u>	<u>\$1,687,510.00</u>	<u>\$1,706,180.00</u>

Subsidiary surpluses at the dates of acquisition were: Company B, \$82,000.00; Company C, \$150,000.00.

The first mortgage bonds of Company A were sold at 97 on January 1, 1932, and matured in twenty years. Annual deposits of \$25,000.00 with a sinking fund trustee, and annual sinking fund reserve provisions of \$25,000.00, are required.

Inventories on December 31, 1933, were as follows:

	<u>A</u>	<u>B</u>	<u>C</u>
Raw Materials	\$ 58,790.00	\$ 46,290.00	\$ 38,280.00
Goods in Process	68,015.00	55,816.00	50,510.00
Finished Goods	38,210.00	36,712.00	48,075.00
Total	<u>\$165,015.00</u>	<u>\$138,818.00</u>	<u>\$136,845.00</u>

The above inventories of Companies B and C include finished goods purchased from Company A, on which the latter company made profits of \$4,700.00 and \$3,950.00, respectively.

At the close of the year 1933, 10% dividends on capital stock were declared by each company, payable January 15, 1934.

The notes payable of Company B were given to Company A for purchases from that company.

Prepare consolidated statements of operations and surplus, and a consolidated balance sheet. Will the consolidated operating statement be true in every respect? Why?

Problem 50-3. Company X purchased a 90% interest in the stock of Company Y and an 80% interest in the stock of Company Z, on January 1, 1933, and June 30, 1934, respectively. Company Z's profits for 1934 are to be regarded as having been earned proportionately through the year. The following trial balances were drawn from the books of the three companies on December 31, 1934:

<u>Debits</u>	<u>Company X</u>	<u>Company Y</u>	<u>Company Z</u>
Cash.....	\$ 50,000.00	\$ 40,000.00	\$ 30,000.00
Accounts Receivable.....	210,000.00	200,000.00	320,100.00
Notes Receivable.....	335,000.00	85,000.00	135,000.00
Inventories:			
Raw Materials.....	80,000.00	60,000.00	90,000.00
Goods in Process.....	140,000.00	100,000.00	150,000.00
Finished Goods.....	90,000.00	75,000.00	85,000.00
Investment in Stock of Co. Y.	725,000.00		
Investment in Stock of Co. Z.	1,050,000.00		
Land.....	60,000.00	20,000.00	35,000.00
Buildings.....	350,000.00	200,000.00	225,000.00
Machinery.....	500,000.00	150,000.00	350,000.00
Purchases—Raw Materials...	645,000.00	370,000.00	429,900.00
Direct Labor.....	495,000.00	305,000.00	345,000.00
Manufacturing Expenses.....	185,000.00	150,000.00	205,000.00
Selling Expenses.....	95,000.00	35,000.00	60,000.00
General Expenses.....	40,000.00	20,000.00	60,000.00
	<u>\$5,050,000.00</u>	<u>\$1,810,000.00</u>	<u>\$2,520,000.00</u>
<u>Credits</u>			
Notes Payable.....	\$ 50,000.00	\$ 70,000.00	\$ 150,000.00
Accounts Payable.....	60,000.00	65,000.00	100,000.00
Bonds Payable, 6%.....	500,000.00		
Premium on Bonds.....	35,000.00		
Reserve for Depreciation:			
Buildings.....	30,000.00	25,000.00	60,000.00
Machinery.....	65,000.00	35,000.00	60,000.00
Sales.....	1,480,000.00	1,010,000.00	1,245,000.00
Capital Stock.....	2,500,000.00	500,000.00	500,000.00
Surplus.....	330,000.00	105,000.00	405,000.00
	<u>\$5,050,000.00</u>	<u>\$1,810,000.00</u>	<u>\$2,520,000.00</u>

Company X has adopted the policy of debiting the investment accounts with subsidiary profits, and crediting them with subsidiary losses and dividends, but has not as yet adjusted the investment accounts for the current year's profits. All three companies paid 8% dividends on December 31, 1933, and December 31, 1934.

The bonds of Company X were issued on July 1, 1934, and mature in ten years; the first interest coupon is due January 1, 1935.

Allow depreciation at 3% on buildings and 10% on machinery. Intercompany purchases and sales during 1934 aggregated

\$380,000.00. Intercompany receivables and payables on December 31, 1934, on open account, amount to \$45,000.00, and on notes, \$60,000.00.

Intercompany profits in inventories are shown below:

	DECEMBER 31, 1933		DECEMBER 31, 1934		
	Intercompany Profit		Total Value	Intercompany Profit	
	Amount	Made by		Amount	Made by
Raw Materials:					
Company X.....	\$5,000.00	Co. Y	\$100,000.00	\$4,500.00	Co. Y
Company Y.....	4,000.00	Co. Z	75,000.00	3,000.00	Co. Z
Company Z.....	4,000.00	Co. Y	65,000.00	2,500.00	Co. Y
Goods in Process:					
Company X.....	6,000.00	Co. Y	125,000.00	6,000.00	Co. Y
Company Y.....	6,000.00	Co. Z	140,000.00	7,000.00	Co. Z
Company Z.....	5,000.00	Co. Y	145,000.00	4,500.00	Co. Y
Finished Goods:					
Company X.....	4,000.00	Co. Y	85,000.00	2,000.00	Co. Y
Company Y.....	2,500.00	Co. Z	70,000.00	3,500.00	Co. Z
Company Z.....	2,500.00	Co. Y	65,000.00	2,500.00	Co. Y

Prepare consolidated statements.

Problem 50-4. From the following trial balances and supplementary data, prepare consolidated statements as follows: cost of sales, profit and loss, surplus, and balance sheet.

TRIAL BALANCES			
DECEMBER 31, 1935			
	Company X	Company Y	Company Z
Cash.....	\$ 40,650	\$ 26,550	\$ 35,000
Accounts Receivable.....	55,000	50,000	70,000
Inventories.....	100,000	65,000	65,000
Investment in Common Stock:			
Company Y, 95%.....	120,000		
Company Z, 85%.....	115,000		
Investment in Preferred Stock:			
Company Z, 60%.....	45,000		
Investment in Bonds:			
Company Y, 100%.....	80,000		
Company Z, 50%.....	47,500		
Bldgs. and Machinery, Dep'd. Value..	267,000	235,000	300,000
Bond Discount.....		3,200	
Raw Material Purchases.....	408,000	280,000	300,000
Direct Labor.....	305,000	270,000	240,000
Manufacturing Expense.....	194,000	190,000	160,000
Depreciation.....	15,550	19,000	15,000
Selling and General Expense.....	70,000	50,000	59,600
Bond Interest Expense.....		4,000	6,000
	<u>\$1,862,700</u>	<u>\$1,192,750</u>	<u>\$1,250,600</u>

	<u>Company X</u>	<u>Company Y</u>	<u>Company Z</u>
Accounts Payable.....	\$ 93,300	\$ 62,000	\$ 51,500
Bonds Payable—5-year Issues.....		80,000	100,000
Bond Premium.....			3,600
Capital Stock:			
Common.....	400,000	50,000	100,000
Non-Participating 7% Preferred....	150,000	25,000	75,000
Surplus.....	101,200	75,750	45,500
Sales.....	1,115,000	900,000	875,000
Bond Interest.....	3,200		
	<u>\$1,862,700</u>	<u>\$1,192,750</u>	<u>\$1,250,600</u>

Company X's stock investments are carried at cost, and were acquired as follows:

- Common stock of Company Y, January 1, 1935.
- Common stock of Company Z, January 1, 1934.
- Preferred stock of Company Z, January 1, 1935.

On December 31, 1934, Company X's inventory contained finished goods on which profits had been made by Companies Y and Z in the respective amounts of \$2,500.00 and \$4,000.00.

The Surplus accounts are analyzed as follows:

	<u>Com- pany X</u>	<u>Com- pany Y</u>	<u>Com- pany Z</u>
Balance, January 1, 1934.....	\$ 84,550	\$55,250	\$39,900
Dividend from Company Z.....	5,100		
Net Profit from Operations.....	60,400	30,000	31,100
Total.....	<u>\$150,050</u>	<u>\$85,250</u>	<u>\$71,000</u>
Dividends Paid:			
Common Stock.....	\$ 24,000	\$ 3,000	\$ 6,000
Preferred Stock.....		1,750	5,250
Total.....	<u>\$ 24,000</u>	<u>\$ 4,750</u>	<u>\$11,250</u>
Balance, December 31, 1934.....	\$126,050	\$80,500	\$59,750
Dividends Received:			
Company Y: Common.....	2,850		
Company Z: Common.....	7,650		
Preferred.....	3,150		
Discount on Company Y Bonds Purchased....	4,000		
Total.....	<u>\$143,700</u>	<u>\$80,500</u>	<u>\$59,750</u>
Dividends Paid, December 31, 1935:			
Common.....	\$ 32,000	\$ 3,000	\$ 9,000
Preferred.....	10,500	1,750	5,250
Total.....	<u>\$ 42,500</u>	<u>\$ 4,750</u>	<u>\$14,250</u>
Balance, December 31, 1935.....	<u>\$101,200</u>	<u>\$75,750</u>	<u>\$45,500</u>

The accounts receivable and accounts payable include, on December 31, 1935, intercompany accounts as follows:

	PER BOOKS OF		
	Com- pany X	Com- pany Y	Com- pany Z
Due from Company Y to Company X.....	\$24,250	\$24,250	
Due from Company Z to Company X.....	16,500		\$18,000

Bonds of Company Y were acquired direct from Company Y at 95 on the date of issuance, January 1, 1935.

Bonds of Company Z were issued January 1, 1933, at 106; \$50,000.00 par value were acquired by Company X on July 1, 1935, at 95.

Company Y has paid its bond interest for the year; Company Z has paid its interest to outside bondholders and has credited Company X with the interest due that company. This interest has not, however, been taken up by Company X.

Intercompany sales during the year ended December 31, 1935, were:

	To COMPANY		
	X	Y	Z
By Company:			
X.....		\$75,000.00	\$30,000.00
Y.....	\$70,000.00		25,000.00
Z.....	80,000.00	65,000.00	

Summary of Inventories

	Company X	Company Y	Company Z
December 31, 1934:			
Raw Materials.....	\$ 40,000.00	\$25,000.00	\$10,000.00
Goods in Process....	25,000.00	25,000.00	20,000.00
Finished Goods.....	35,000.00	15,000.00	35,000.00
Total.....	<u>\$100,000.00</u>	<u>\$65,000.00</u>	<u>\$65,000.00</u>
December 31, 1935:			
Raw Materials.....	\$ 35,000.00	\$22,000.00	\$15,000.00
Goods in Process....	30,000.00	17,000.00	20,000.00
Finished Goods.....	30,000.00	35,000.00	20,000.00
Total.....	<u>\$ 95,000.00</u>	<u>\$74,000.00</u>	<u>\$55,000.00</u>

Unrealized profit in inventories on December 31, 1935:

	PROFIT MADE BY COMPANY		
	X	Y	Z
Raw Materials Inventory of Company Y	\$3,500.00		
Goods in Process Inventory of Company Y	3,000.00		
Finished Goods Inventory of Company X		\$3,000.00	\$3,500.00
Finished Goods Inventory of Company Y	1,000.00		1,500.00
Total.....	<u>\$7,500.00</u>	<u>\$3,000.00</u>	<u>\$5,000.00</u>

Problem 50-5. On March 31, 1934, the general ledger trial balances of three related companies, after all adjustments have been applied, are as follows:

<u>Debits</u>	<u>The Weymouth Company</u>	<u>The Benson Company</u>	<u>The Vending Corporation</u>
Cash.....	\$ 43,500	\$ 94,000	\$ 100,000
Notes Receivable.....	85,000	250,000	50,000
Accounts Receivable—Customers.....	135,500	750,000	400,000
Accounts Receivable—Sundry..	4,150	25,000	10,000
Inventories—April 1, 1933:			
Finished Goods.....	310,500	800,000	352,500
Work in Process.....	45,500	500,000	100,000
Raw Materials and Supplies.....	105,000	500,000	150,000
Investments:			
The Vending Corporation ..		1,025,050	
The Weymouth Co.—Common....		345,500	
The Weymouth Co.—Preferred...		86,000	12,500
Property and Equipment.....	285,000	2,000,000	400,000
Prepaid Insurance.....	8,800	25,000	7,500
Labor and Manufacturing Expenses	210,000	918,000	291,200
Purchases.....	515,000	2,500,000	400,000
Selling Expenses.....	85,000	400,000	120,000
Administration and General Expenses	35,000	125,000	50,000
Interest Expense.....	19,600	50,000	15,000
Cash Discounts on Sales.....	14,500	50,000	15,000
Returned Sales.....	44,000	125,000	100,000
Federal Income Tax Provision.	6,500	110,000	12,500
Dividends:			
Preferred Stock.....	6,000	70,000	
Common Stock.....	18,000	300,000	50,000
	<u>\$1,976,550</u>	<u>\$11,048,550</u>	<u>\$2,636,200</u>
<u>Credits</u>			
Notes Payable.....	\$ 203,000	\$ 493,070	\$ 103,650
Accounts Payable.....	196,300	235,500	175,000
Reserve for Depreciation.....	91,500	500,000	250,000
Reserve for Federal Income Taxes....	6,500	110,000	12,500
Reserve for Bad Debts.....	6,800	50,000	7,500
Preferred Capital Stock—Non-participating.....	100,000	1,000,000	
Common Capital Stock (Par Value \$100.00 per share).....	300,000	2,000,000	500,000
Surplus, April 1, 1933.....	89,500	1,501,800	479,000
Sales.....	980,000	5,000,000	1,100,000
Interest Income.....		25,000	3,700
Cash Discounts on Purchases.....	10,000	30,000	8,000
Profit and Loss.....	7,050*	42,480	3,750*
Income from Investments.....		60,700	600
	<u>\$1,976,550</u>	<u>\$11,048,550</u>	<u>\$2,636,200</u>

* Debit.

The Benson Company owns 80% of the capital stock of The Vending Corporation, and 90% of the common stock and 75% of the preferred stock of the Weymouth Company. The Vending Corporation owns 10% of the preferred stock of the Weymouth Company.

Inventories on March 31, 1934, are as follows:

	The Weymouth Company	The Benson Company	The Vending Corporation
Finished goods.....	\$280,000.00	\$905,000.00	\$301,700.00
Work in process.....	61,450.00	312,500.00	112,000.00
Raw materials and supplies.....	112,900.00	480,000.00	180,000.00

The Profit and Loss accounts are analyzed as follows:

	The Weymouth Company	The Benson Company	The Vending Cor- poration
Debits:			
Fire loss.....		\$ 1,500.00	
Provision for bad debts.....	\$5,000.00	10,000.00	\$5,000.00
Additional Federal income tax for fiscal year 1932.....	2,050.00	3,290.00	
Total debits.....	<u>\$7,050.00</u>	<u>\$14,790.00</u>	<u>\$5,000.00</u>
Credits:			
Profit on sale of automobile.....			\$ 750.00
Refund of 1930 income tax.....			500.00
Equity in increase of surplus of sub- sidiaries during the year:			
The Weymouth Company.....		\$20,430.00	
The Vending Corporation.....		36,840.00	
	<u>—</u>	<u>\$57,270.00</u>	<u>\$1,250.00</u>

The "equities in increase of surplus" were computed as follows:

	The Weymouth Company	The Vending Corporation
Net profit for the year.....	\$48,750.00	\$94,800.00
Surplus charges*—credits in Profit and Loss acct.	2,050.00*	1,250.00
Increase in Surplus, before dividends.....	<u>\$46,700.00</u>	<u>\$96,050.00</u>
Dividends paid (dividends received have been credited to Income from Investments):		
Preferred.....	\$ 6,000.00	
Common.....	18,000.00	\$50,000.00
Total dividends.....	<u>\$24,000.00</u>	<u>\$50,000.00</u>
Increase in Surplus.....	<u>\$22,700.00</u>	<u>\$46,050.00</u>
Per cent of common stock owned.....	90%	80%
Equity in increase of Surplus.....	<u>\$20,430.00</u>	<u>\$36,840.00</u>

Included in the sales of The Vending Corporation are sales of \$75,000.00 to The Weymouth Company, of which amount \$2,000.00 were returned; \$15,000.00 of this merchandise, which cost \$11,150.00 to manufacture, remained in the purchaser's materials inventory on March 31, 1934. Using the alternative form of working papers given in the chapter, prepare the consolidated statements for the year.

QUESTIONS AND PROBLEMS ON CHAPTER 51

QUESTIONS

Question 51-1. Two concerns in similar lines contemplate consolidating their businesses. You are requested to examine their books of account and report on the matters germane to the contemplated merger. What data would you probably present in your report?

Question 51-2. In a report upon a proposed amalgamation of two companies, state how you would treat the following points in arriving at the earning power of each concern. Give reasons for your treatment:

- (a) Anticipated profits on contracts in process.
- (b) Insurance of any description.
- (c) Wages paid general workmen.
- (d) Salaries paid officers and directors.
- (e) Depreciation of plant and equipment.
- (f) Bad debt reserve.
- (g) Repairs, renewals, and replacement of plant and equipment.

Question 51-3. A client comes to you for assistance in accounting matters involved in the consolidation of five manufacturing companies. He informs you that it has been decided that each concern should send him a balance sheet as at the close of its last fiscal year, and profit and loss statements for each of the past five years, so that a preliminary statement may be prepared showing the approximate amount of common and preferred stock of the new corporation to be turned over to each of the five companies in settlement for its net assets, and so forth.

The plan outlined for consolidation includes the giving of preferred stock for all tangible assets less liabilities, and common stock for the goodwill based upon past profits. The client asks you to prepare for him a letter to be sent to each of these five companies, requesting such further information as might not ordinarily appear on a balance sheet and Profit and Loss account; all of which information it would be necessary for you to have in order to prepare the preliminary figures referred to above. Outline the information which you would request in such a letter.

Question 51-4. Why is it usually not practicable to effect a consolidation of several companies by issuance of common stock only?

Question 51-5. In a statement of the earnings of a business to be sold on the basis of its earning capacity, how should the question of interest paid on accounts payable, on bills payable, and on loans be treated?

Question 51-6. In the merger of several companies, the following condition is encountered:

Company *A* had borrowed \$50,000.00 from Company *B* and had given notes secured by its capital stock of \$50,000.00. The notes were past due, and Company *A* considered the liability as a sale of capital stock to Company *B*. Company *B* carried the asset as notes receivable. The terms of the merger call for the surrender of stocks in the merging companies for stock in the merged company. The values of the capital stocks of the merging companies were determined by appraisal.

What would be your comments and recommendations in respect to this situation?

Question 51-7. In a balance sheet to be used for financing, to what extent, if any, should an auditor give effect to transactions or developments occurring subsequent to the balance sheet date?

PROBLEMS

Problem 51-1. *X* Corporation desired to obtain control of Corporation *B*, and to that end began buying its common stock wherever it could be found. As a result, the price demanded for the stock advanced to such an extent that, in June 1933, *X* Corporation discontinued this plan of purchase. In the meantime, it had bought 20,000 shares of stock at prices ranging from \$20.00 to \$50.00 and averaging \$36.00. It had also acquired 12,000 shares by an exchange, from its treasury stock, of one half share of *X* preferred and one share of *X* common for each share of *B* stock.

In November 1933, by direct negotiation, the directors of Corporation *B* (who controlled 60% of its stock) agreed to sell *X* Corporation all its assets, except cash, on December 31, 1933, on the following basis:

- (1) For sound value of fixed assets, as determined by appraisal, Corporation *B* is to be paid 10% in cash and 90% in preferred stock of *X* Corporation, at par, \$100.00 per share.

- (2) For current assets and prepaid expenses, at 90% of book value, Corporation B is to receive cash, less the amount of current liabilities, which are to be assumed by X Corporation.
- (3) Corporation B is to receive common stock of X Corporation (at par, \$50.00 per share) as payment for goodwill, including all intangibles, the amount to be determined by capitalizing at 20% the average net earnings for the five years 1929 to 1933, inclusive, in excess of \$2.00 per share on 100,000 shares of outstanding stock.

In determining such net profits, adjustments are to be made to bring such items as depreciation and capitalization of fixed asset charges in the several years to the basis to be determined by a retrospective appraisal. Administrative salaries are to be adjusted to \$24,000.00 for each year in which greater amounts were paid.

An audit carried out before the above settlement adjustments discloses the following facts:

	<u>Net Profits</u>	<u>Adminis- trative Salaries</u>	<u>Depreciation Charges</u>	<u>Net Addition to Fixed Asset Accounts</u>
1929	\$ 81,000.00	\$15,000.00	\$198,000.00	\$ 40,000.00
1930	192,400.00	30,000.00	207,000.00	12,000.00
1931	178,000.00	21,000.00	214,000.00	202,000.00
1932	313,000.00	70,000.00	242,000.00	300,000.00
1933	297,000.00	62,500.00	251,000.00	84,200.00

The audit also discloses that profits had been augmented by gains in sales of fixed assets over depreciated values, as follows:

1931.....	\$14,100.00
1932.....	16,800.00
1933.....	1,300.00

The appraisal report shows the following:

	<u>Proper Additions to Fixed Assets</u>	<u>True Depreciation</u>
1929.....	\$ 62,000.00	\$ 140,000.00
1930.....	18,000.00	140,400.00
1931.....	260,000.00	146,000.00
1932.....	297,000.00	157,200.00
1933.....	91,800.00	165,000.00
Reproduction value of fixed assets—Dec. 31, 1933		\$6,200,000.00
Depreciation.....		2,800,000.00
Sound value.....		<u>\$3,400,000.00</u>

The true depreciation shown by appraisal is presumed to be sufficient to absorb all of the cost of an asset during the years of its use, so that there should be neither profit nor loss at the time of sale or scrapping.

The condensed balance sheet of Corporation *B*, December 31, 1933, is as follows:

Assets	
Cash.....	\$ 81,000.00
Receivables.....	56,000.00
Inventories.....	574,000.00
Prepaid Expenses.....	9,000.00
Mortgage Sinking Fund.....	400,000.00
Plant.....	\$4,000,000.00
Less Depreciation.....	<u>2,400,000.00</u>
Organization Expense.....	80,000.00
Patents and Trade-Marks.....	<u>1,000,000.00</u>
	<u>\$3,800,000.00</u>
Liabilities	
Notes and Accounts Payable.....	\$ 200,000.00
Long-term Notes.....	100,000.00
Mortgage on Plant, Due January 1, 1934.....	1,000,000.00
Common Stock—100,000 Shares, No Par Value.....	2,000,000.00
Surplus.....	500,000.00
	<u>\$3,800,000.00</u>

X Corporation has sufficient shares of capital stock, authorized but unissued, to comply with the settlement terms, but to meet the cash requirements it issues 6% gold notes amounting to \$1,000,000.00, which are taken by a syndicate for cash at 96.

After the deal is consummated, Corporation *B* immediately liquidates all liabilities, pays the costs of settlement and liquidation amounting to \$20,000.00, and distributes all assets in kind to the stockholders.

From the foregoing, you are required to prepare:

- (a) A tabulated statement showing the determination of amounts needed for settlement purposes.
- (b) All journal entries to give effect to the above transactions on the books of Corporation *B*.
- (c) All journal entries to give effect to the above transactions on the books of *X* Corporation.

Problem 51-2. In order to consolidate the businesses whose statements appear below, The *X Y* Corporation is organized with the following capitalization:

First Mortgage 5% Bonds—\$3,000,000.00.
 Preferred Stock—\$100.00 Par—\$5,000,000.00.
 Common Stock—\$10.00 Par—\$1,000,000.00.

Balance Sheet—December 31, 1933

	<i>B Co.</i>	<i>D and E</i>	<i>G Co.</i>
Cash.....	\$ 45,000	\$ 58,000	\$ 39,000
Accounts Receivable.....	300,000	410,000	210,000
Inventories.....	750,000	780,000	300,000
Plant Property.....	1,400,000	1,010,000	1,440,000
Goodwill.....			300,000
	<u>\$2,495,000</u>	<u>\$2,258,000</u>	<u>\$2,289,000</u>
Accounts Payable.....	\$ 360,000	\$ 465,000	\$ 570,000
Accrued Bond Interest.....	15,000		
Bonds Payable, 6%.....	500,000		
Reserve for Bad Debts.....	25,000	24,000	11,000
Reserve for Depreciation.....	175,000	280,000	102,000
Partners' Capital.....		1,489,000	
Capital Stock.....	1,000,000		1,500,000
Surplus.....	375,000		106,000
Sinking Fund Reserve.....	45,000		
	<u>\$2,495,000</u>	<u>\$2,258,000</u>	<u>\$2,289,000</u>

Profit and Loss Account, 1933

Sales.....	\$1,550,000	\$1,200,000	\$ 960,000
Cost of Sales.....	700,000	580,000	500,000
Gross Profit on Sales.....	\$ 850,000	\$ 620,000	\$ 460,000
Miscellaneous Income:			
Bank Interest.....	1,000	1,200	600
Profit on Insurance Recovery (Account of Plant Unit Destroyed by Fire)...		10,000	
Profit on Sale of Real Estate.....	15,000		
Total.....	<u>\$ 866,000</u>	<u>\$ 631,200</u>	<u>\$ 460,600</u>
Deduct:			
Management Salaries.....	\$ 80,000	\$ 16,000	\$ 30,000
Selling and General Expenses.....	460,000	300,000	280,000
Interest on Bonds.....	30,000		
Interest on Bills Payable.....	7,000	14,000	6,000
Sinking Fund Reserve.....	15,000		
Federal Taxes.....	51,000	28,500	8,300
Total Deductions.....	<u>\$ 643,000</u>	<u>\$ 358,500</u>	<u>\$ 324,300</u>
Net Profit.....	<u>\$ 223,000</u>	<u>\$ 272,700</u>	<u>\$ 136,300</u>

The merger agreement contains the following provisions:

- (a) That the net tangible assets shall be paid for on the basis of 20% in cash, 30% in first mortgage bonds, and 50% in preferred stock of the new company.
- (b) That the plant property be taken over at appraised sound values on December 31, 1933, as follows:

<i>B Company</i>	\$1,200,000.00
<i>D and E</i>	1,350,000.00
<i>G Company</i>	1,520,000.00

- (c) That allowance be made to the vendors for goodwill, payable in common stock, the amount to be determined thus: Two and one-half times the net earnings from operations for the year 1933, before considering any actual interest items (either debit or credit) or Federal taxes, and after fixing management salaries at 4% of the net sales for the year; also after deducting 8% interest on the net tangible assets at December 31, 1933.
- (d) That the remaining bonds be sold to underwriters at 99, to obtain the cash required for payment to the vendors, and for redemption of the *B* Company bonds, which have been called for redemption on January 1, 1934, at 102½.

Assuming that the above transactions are properly carried out, prepare a balance sheet showing the position of The *XY* Corporation as of January 1, 1934. Prepare also statements showing the amount of cash, bonds, preferred stock, and common stock received by each of the vendor companies.

Problem 51-3. The following is the balance sheet of Margo Manufacturing Company as at December 31, 1933:

Assets	
Current:	
Cash in Banks and on Hand.....	\$ 50,000
Customers' Notes and Accounts Receivable, Less Reserve.....	300,000
Inventories.....	1,000,000
Total Current Assets.....	<u>\$1,350,000</u>
Land, Bldgs., and Machinery, as appraised, Less Res. for Dep'n...	6,200,000
Prepaid Expenses.....	20,000
Goodwill.....	1,000,000
	<u>\$8,570,000</u>
Liabilities	
Current:	
Notes Payable—Banks.....	\$ 800,000
Trade Acceptances.....	400,000
Accounts Payable and Accrued Expenses.....	500,000
Total Current Liabilities.....	<u>\$1,700,000</u>
Funded Debt:	
First Mortgage 6½% Gold Bonds.....	\$2,100,000
Serial Gold Notes.....	400,000
	<u>2,500,000</u>
Capital Stock—Authorized and Issued:	
Preferred, 20,000 Shares 6% Cumulative, Par Value \$100.00 each.....	\$2,000,000
Common, 15,000 Shares, Par Value \$100.00 each.....	1,500,000
	<u>3,500,000</u>
Surplus:	
Earned.....	\$ 70,000
From Appraisal of Plant.....	800,000
	<u>870,000</u>
	<u>\$8,570,000</u>

In order to provide the working capital necessary for the continuance of the business, it is proposed to reorganize according to the following plan:

- (1) The authorized capital stock to consist of 50,000 shares of 6% cumulative preferred of a par value of \$50.00 a share, and 100,000 shares of no-par common.
- (2) The preferred and common stock now outstanding to be surrendered, the present stockholders to receive, for each share of preferred stock now held, one share of new preferred of \$50.00 par, one share of no-par common, with warrant entitling to purchase, on or before June 1, 1937, one-half share of no-par common at \$35.00 a share; for each share of common stock now held, two shares of no-par common with warrant entitling to purchase, on or before June 1, 1937, one-half share of no-par common at \$35.00 per share.
- (3) One of the branch plants to be sold for a cash consideration of \$600,000.00, and the serial gold notes of \$400,000.00, which are secured by a mortgage on this plant, to be paid. The plant to be sold is carried on the books and included in the fixed assets at \$750,000.00, the appraised value less depreciation.
- (4) \$1,250,000.00 of 7% debentures to be issued and sold at 95, the sale carrying with it a bonus of 5,000 shares of no-par common stock.
- (5) The proceeds of the proposed financing to be applied to reduce bank loans, trade acceptances, and accounts payable by \$600,000.00, \$350,000.00, and \$400,000.00, respectively, and to increase the cash balance.
- (6) By resolution of the directors, all Surplus accounts to be closed and their balances merged, after the goodwill has been written off, in the stated value of the no-par common stock.

Prepare a balance sheet, as of December 31, 1933, after giving effect to the transactions set forth in the foregoing plan of reorganization.

Problem 51-4. The directors of five corporations, all situated in the same state, desire to consolidate. With that end in view they draw up and sign an agreement to be submitted to all stockholders of record, setting forth the plan of the proposed consolidation and stating its purposes and advantages.

You are called upon to audit the books of account and records

of the five companies and to present a certified balance sheet showing the book value of the capital stock of each company. You are then to prepare a schedule showing how much stock of the new corporation should be issued in payment for the stock of each of the companies about to be consolidated.

You are next required to prepare a balance sheet giving effect to the consolidation, after it has been unanimously approved by the several companies.

The result of your audit of the individual companies, as of January 1, 1929, accepted by the several boards of directors, was as follows:

	Carter Yarn Co.	Atlas Mills	Ladd Cotton Mills	Reliable Finishing Co.	Excelsior Print Works
Assets					
Cash.....	\$ 3,198	\$ 167,071	\$ 54,316	\$ 8,464	\$ 7,800
Inventories	402,649	376,476	384,627	32,904	265,644
Fuel and Supplies ..	17,270	18,759	20,241	2,876	14,290
Accts. Receivable:					
Selling Agents....	24,756	130,974	42,420		
Others.....	2,200	55,402	2,125	98	10,456
Mill Store Account.			17,846		
Ins. Unexpired.....	2,500	4,250	16,241	387	564
Interest Accrued... .	1,451	2,341	1,298	963	1,400
Property and Plant.	950,000	1,054,674	1,265,455	175,602	141,750
Other Real Estate..	75,000		24,000		
Investments—at cost; detailed below.....	25,000		655,810		
	<u>\$1,504,024</u>	<u>\$1,809,947</u>	<u>\$2,484,379</u>	<u>\$221,294</u>	<u>\$441,904</u>
Liabilities					
Notes Payable.....	\$ 175,000	\$ 300,000	\$ 75,000	\$ 62,850	\$110,000
Accounts Payable..		3,675	22,380	8,444	121,864
Wages Accrued....			5,437		2,675
Reserves for 1928					
Income Taxes....		14,645	16,245		14,475
Res. for Dep'n.....	650,000	452,853	928,332		30,743
Surplus.....	179,024	38,774	486,223		62,147
Profit for Previous Six Months.....			450,762		
Capital Stock—					
Common.....	500,000	1,000,000	500,000	150,000	100,000
	<u>\$1,504,024</u>	<u>\$1,809,947</u>	<u>\$2,484,379</u>	<u>\$221,294</u>	<u>\$441,904</u>

Carter Yarn Co. owns 250 shares of capital stock of Excelsior Print Works, and Ladd Cotton Mills owns 11,260 shares of Atlas Mills.

The capital stock of the companies is stated on the following page.

	<u>Shares</u>	<u>Par Value</u>
Carter Yarn Co.....	25,000	\$ 20.00
Atlas Mills.....	20,000	50.00
Ladd Cotton Mills.....	5,000	100.00
Reliable Finishing Co.....	1,500	100.00
Excelsior Print Works..	1,000	100.00

The new corporation is organized under the name of the Carter Ladd Corporation, with an authorized capital stock of 75,000 shares, par value \$100.00 each.

Reliable Finishing Co. and Excelsior Print Works are taken into the merger at 100% of their net worth per books, exclusive of intercompany stockholdings; and the other three companies, at 80%. This is to be computed to the nearest whole number of shares and the balance applied to surplus. In determining the final distribution of Carter Ladd Corporation stock, proper recognition is to be given to intercompany stockholdings.

Problem 51-5. Two companies propose to consolidate; their balance sheets appear as follows:

	<u>Company X</u>	<u>Company Y</u>
Current Assets.....	\$ 95,000.00	\$ 45,000.00
Investment in Stock of Company X—250 shares..		50,000.00
Fixed Assets (appraised values).....	110,000.00	120,000.00
	<u>\$205,000.00</u>	<u>\$215,000.00</u>
Current Liabilities	\$ 25,000.00	\$ 35,000.00
Fixed Liabilities	50,000.00	40,000.00
Capital Stock (1,000 shares each).....	50,000.00	100,000.00
Surplus.....	80,000.00	40,000.00
	<u>\$205,000.00</u>	<u>\$215,000.00</u>

Company Z is organized to acquire the old companies by issuance of common stock on the basis of net asset values. No consideration is to be given to earnings, but the two companies are to be regarded as having equal goodwills.

Give two solutions, showing how much of the Company Z stock should be issued to each old company for distribution to its stockholders. In each case submit a balance sheet of Company Z after the merger, assuming that the old companies are dissolved.

QUESTIONS AND PROBLEMS ON CHAPTER 52

QUESTIONS

Question 52-1. If two countries are on a gold basis, what may affect the par rate between the two countries?

Question 52-2. If one country is on a gold basis and one is on a silver basis, what additional factor may change the mint par rate?

Question 52-3. Does the change in the balance of trade between two countries have any effect upon the mint par rate?

Question 52-4. What is meant by specie points or gold points?

Question 52-5. What factors influence the rise and fall in the current exchange rates?

Question 52-6. What is meant by a banker's bill? By a commercial bill? Distinguish between a short bill and a long bill; between a documentary bill and a clean bill.

PROBLEMS

Problem 52-1. (1) Make the following conversions at par rates:

- (a) \$8,625.00 to pounds.
- (b) \$8,080.00 to francs.
- (c) 5,500 marks to dollars.
- (d) £350 10s. 6d. to dollars.

(2) Convert \$25,000.00 at the following rates (value in cents) quoted as current as of April 20, 1934:

- (a) London cables, 516.608.
- (b) London checks, 516.21.
- (c) Paris cables, 6.647.
- (d) Paris checks, 6.64.
- (e) German checks, 39.58.

(3) Convert 25,000 units of the respective foreign moneys to dollars at the rates in (2).

Problem 52-2. Compute the interest on £605 12s. 6d. for

85 days at 6%, using: (a) 360 days to the year; and (b) 365 days to the year.

Problem 52-3. The following is a summary of the account of a bank with its London correspondent during January:

<u>Date</u>	<u>Debits</u>
1—Balance, £600 at 5.18	
4—Remittance, 30-day bill, £75 10s. at 5.165	
10—Remittance, sight bill, £100 15s. 6d. at 5.192	
24—Cable, £200 at 5.17	
	<u>Credits</u>
	3—Draft, sight, £500 at 5.185
	15—Draft, demand, \$6,475.00 at 5.18
	29—Cable, £100 at 5.155

Set up the account as it should appear on the books of the bank after closing, January 31, ignoring interest. The current rate on January 31 is 5.14.

Problem 52-4. *A* in London, in current account with *B* of New York, engages an accountant to prepare a statement, to be mailed to *B*, from the following data:

	<u>Debits</u>	
May 12.....	£750	
May 30.....	117	
June 12.....	340	
July 1.....	<u>150</u>	
Total debits.....		£1,357
	<u>Credits</u>	
June 10.....	£500	
June 30.....	<u>300</u>	
Total credits.....		<u>800</u>
Balance.....		<u>£ 557</u>

Find the average due date of the account and the interest at 5% to July 1, considering 365 days to the year. State the interest in pounds, shillings, and pence.

Problem 52-5. A. B. Crow made the following sales to Thorne & Sons of Paris.

<u>Date</u>	<u>Amount</u>	<u>Exchange Rate at Date of Sale</u>
May 5.....	\$2,500.00	6.64
July 1.....	5,000.00	6.60
August 28.....	6,000.00	6.685

Thorne & Sons paid the entire bill by cable transfer on September 10, at which date the rate was 6.725.

Make entries in journal form and also show the personal accounts as they would appear on the books of both parties, assuming that:

- (a) Billings were in United States money.
- (b) Billings were in French money on the basis of the rates prevailing at the dates of shipment.

Assume no changes in rates between dates of shipment and arrival of goods, and between making and receiving remittance.

Problem 52-6. From the following data, prepare entries for the corporation's books, to record all exchange transactions, the exchange position, and profits realized. Show also what the result would have been if the exchange risk had not been covered.

A United States corporation with a branch in a foreign country ships raw material to this branch, in which a certain product is manufactured and sold. The branch remits the net proceeds as soon as the sales are realized in cash.

The unit of this foreign currency is the crown, worth sixty cents at par of exchange.

When it appears that the rate of exchange may decline, the United States corporation guards against losses by selling forward the foreign currency to be collected. For this reason and purpose, the branch costs and expenses, as well as the proceeds from its sales, must necessarily be determined as nearly as possible in advance.

On October 1, when the crown was selling at 30, the United States corporation shipped raw material costing \$30,000.00 and billed the branch for the equivalent of 100,000 crowns, payable December 30.

It was estimated that all manufacturing, selling, administration, and other branch expenses applicable to this venture would be 120,000 crowns and that the product would be all sold by December 30 for 250,000 crowns. The estimate proved to be correct, with one exception: *viz.*, the goods were actually sold and delivered by December 30 for 255,000 crowns, spot cash, f.o.b. factory.

The rate of exchange had, in the meantime, fallen to 20.

Problem 52-7. An English investor is offered a 6%, three-year, £5,000 bond on a 5% basis. Compute the price, and set up a table showing the collection of the income and the amortization of the premium. The present value of 1 at $2\frac{1}{2}\%$ for 6 periods is .8622969.

QUESTIONS AND PROBLEMS ON CHAPTER 53

QUESTIONS

Question 53-1. How would an American importer record the purchase of merchandise in Europe if payment is not to be made for sixty days and the goods are billed in dollars? In pounds? What entry would he make to record the subsequent payment in case the rate of exchange had changed between the date of purchase and the date of payment?

Question 53-2. If cash is remitted by a foreign branch to the home office, payable in foreign currency, how should the transaction be recorded on the two sets of books, and what rate of exchange should govern the conversion?

If the remittance was payable in dollars, what entries would be made on the two sets of books, and what rate would govern the conversion?

Question 53-3. What entries should be made on the two sets of books to record goods sent by the home office to the foreign branch, and what exchange rate should be used for the conversion?

Question 53-4. Assuming that fixed asset accounts are kept on the foreign branch books, how would the branch record a purchase of fixed assets paid for in foreign currency?

How would the branch and the home office record a shipment of machinery from the home office to the branch?

Why is it desirable to keep the branch fixed asset accounts on the home office books? If the fixed asset accounts are kept on the home office books, what entries should be made to record a shipment of machinery by the home office to the branch? What entries would be made to record the acquisition of fixed assets by the branch, paid for in foreign currency?

Question 53-5. At what rate should foreign branch current assets be converted, and what is the reason for its use? What rate should be used for conversion of current liabilities? Why? At what rate should fixed assets be converted?

What rate should be used in converting the inventory at the beginning of the period? What rate should be used for conversion of the balances of the nominal accounts?

PROBLEMS

Problem 53-1. The Soochow Company opened a branch in Liverpool on January 1, 1934. Its transactions with the branch and the branch's own transactions during 1934 are summarized as follows:

- (a) Remittances to the branch:
 - Draft for £2,000, purchased at 5.17.
 - Draft for \$5,000.00, cashed by the branch at 5.18.
- (b) Shipments to the branch:
 - Merchandise costing \$45,000.00, taken up by the branch at 5.18.
 - Merchandise costing \$65,000.00, taken up by the branch at 5.20.
- (c) Sales by the branch:
 - On account, £12,000.
 - For cash, £8,000.
- (d) Collections by the branch on account, £11,500.
- (e) Branch fixed asset acquisitions (fixed asset accounts kept on branch books):
 - Purchased by home office for cash, \$2,000.00; rate, 5.17.
 - Purchased by branch for cash, £2,600; rate 5.20.
- (f) Branch expenses:
 - Paid in cash, £1,750.
 - Not paid, £450.
- (g) Cash remitted to home office:
 - Draft for £5,000, cashed by home office at 5.195.
 - Draft for \$50,000.00, purchased at 5.18.
- (h) Depreciation provided by branch, 10%.
- (i) Branch inventory, December 31, 1934, £7,500.

Make such entries as should appear on the books of the home office and the branch to record the foregoing transactions; close the branch books; prepare the branch profit and loss statement and balance sheet in both currencies; make an entry on the home office books taking up the branch profit; and prepare a statement of the current accounts as they should appear on the two sets of books after closing.

The average rate is 5.185; the current rate, December 31, 1934, 5.21.

Problem 53-2. The trial balance of the London branch of the Speaker Company on December 31, 1934, is shown on the following page.

Cash	£ 7,000	
Accounts Receivable	13,000	
Remittance Account	80,000	
Merchandise Inventory—January 1, 1934	8,000	
Furniture and Fixtures	5,000	
Accounts Payable		£ 1,000
Home Office Current Account		94,000
Sales		85,000
Merchandise from Home Office (at cost)	58,000	
Expenses	9,000	
	<u>£180,000</u>	<u>£180,000</u>

Inventory, December 31, 1934, £8,000.

Assume the following exchange rates:

On the date the furniture and fixtures were purchased, 4.83.

On January 1, 1934, 5.12.

Average rate for the year, 5.20.

On December 31, 1934, 5.14.

The trial balance of the home office books on December 31, 1934, was:

Cash	\$ 26,090	
Accounts Receivable	39,800	
Raw Material Inventory—December 31, 1934	35,000	
Goods in Process Inventory—December 31, 1934	15,000	
Finished Goods Inventory—December 31, 1934	38,000	
London Branch Current Account	484,510	
Land	10,000	
Plant and Equipment	140,000	
Reserve for Depreciation		\$ 42,000
Reserve for Depreciation—London Furniture and fixtures		10,900
Accounts Payable		18,000
Remittances from London Branch		414,000
Reserve for Exchange Fluctuations		2,100
Capital Stock		200,000
Surplus		85,500
Profit and Loss—1934		15,900
	<u>\$788,400</u>	<u>\$788,400</u>

From the foregoing information, prepare:

- (a) Closing entries on the branch books.
- (b) Statement converting the branch trial balance and December 31, 1934, inventory to the dollar values at which the various items should appear in the statements.
- (c) Branch profit and loss statement for the year, from facts shown on the branch books, expressed in both pounds and dollars.
- (d) Branch balance sheet, expressed in both pounds and dollars.
- (e) Journal entries on the home office books, taking up the

branch profit and closing the books, and allowing \$3,000.00 depreciation on the branch furniture and fixtures.

- (f) Transcript of the London Branch Current account on the home office books.
 (g) Combined balance sheet working papers.

Problem 53-3. A New York corporation builds a plant and establishes a branch in Liverpool, England. At the expiration of its fiscal period a trial balance is forwarded to the New York office, as follows:

Cash.....	£ 12,500	
Accounts Receivable.....	187,500	
Remittance Account.....	150,000	
Inventory (end of fiscal period).....	50,000	
Plant (rate at acquisition, 4.88)....	250,000	
Accounts Payable.....		£ 87,500
New York Office.....		337,500
Income from Sales.....		250,000
Expenses.....	25,000	
	<u>£675,000</u>	<u>£675,000</u>

A trial balance of the New York books at the same date was as follows:

Cash.....	\$ 107,625.00	
Liverpool Account.....	1,640,250.00	
Patents.....	2,500,000.00	
Remittance Account.		\$ 772,875.00
Capital Stock.....		3,500,000.00
Expenses.....	25,000.00	
	<u>\$4,272,875.00</u>	<u>\$4,272,875.00</u>

The Remittance account is composed of four sixty-day drafts on Liverpool for £37,500 each, which were sold in New York at \$5.18, \$5.165, \$5.145, and \$5.12, respectively.

Prepare a balance sheet of the New York books after closing, a statement of the assets and liabilities of the Liverpool branch reconciled with the New York books, and combined balance sheet working papers. The rate of exchange on the last day of the fiscal period was 5.10. Any exchange profit or loss may be taken into Surplus.

Problem 53-4. The following is the trial balance of The Farewell Company on December 31, 1934:

Cash.....	\$ 36,600.00
Accounts Receivable.....	351,500.00
Inventories—January 1.....	67,500.00
Plant and Equipment.....	217,800.00

Reserve for Depreciation		\$ 86,000.00
Accounts Payable		69,000.00
Notes Payable		140,000.00
Capital Stock		300,000.00
Surplus		91,940.00
Sales		905,000.00
Purchases	\$ 410,000.00	
Direct Labor	144,000.00	
Manufacturing Expenses	110,000.00	
Selling and General Expenses	199,500.00	
Paris Expense	40,284.00	
Exporting Expense—1934 Shipments	14,756.00	
	<u>\$1,591,940.00</u>	<u>\$1,591,940.00</u>

Inventories—December 31—\$98,000.00

The accounts receivable include an account called Paris Office, of which you make the following analysis:

Balance—January 1, 1934	\$ 85,200.00
Sales (including \$12,000.00 in transit on December 31, 1934)	233,800.00
Total	<u>\$319,000.00</u>
Credits:	
Cash	\$106,560.00
Commission to Manager	11,840.00
Insurance Recovery*	<u>11,000.00</u>
Balance—December 31, 1934	<u>\$189,600.00</u>

* Collection from insurance company at billed price for merchandise lost; the insurance company paid all transportation charges direct to the carrier.

You learn that the Paris office is a branch, to which merchandise is billed at domestic selling prices, to be resold at a mark-up of 20%. The 1934 French selling prices were fixed on January 1, on the basis of the exchange rate then prevailing—.062. The branch was established early in 1933, when the manager was sent abroad with a draft for 125,000 francs, purchased for \$5,000.00. With this draft the manager opened an account in Bank A, against which he draws checks in payment of *all* expenses applying to the foreign business (except his commission); the home office replenishes the fund for the amount of these expenses, as reported, by cable transfers of francs to Bank A, and records the dollar cost thereof as Exporting Expense (ocean freight, insurance, and duty) or as Paris Expense (all other items).

When he makes collections on sales, the Paris manager deposits the cash in Bank B, and immediately withdraws his 10% commission; the home office draws against this balance when exchange rates are favorable. Withdrawals are recorded as follows:

Debits: Cash (for dollars received).

 Paris Expense ($\frac{1}{2}$ of cash debit, for commissions applicable).

 Credit: Paris Office (for total).

On December 31, 1934, the following figures, taken from its memorandum records, are submitted by the Paris office:

Bank balances: *A*, 125,000 francs; *B*, 45,000 francs.

The reconciliations indicate that no checks were outstanding at the beginning or end of the year.

Inventory, at billed price, \$50,220.00. (The inventory on January 1, 1934, was \$40,920.00.)

Accounts receivable, 3,100,000 francs.

Bank statements for the year show totals as follows:

A: Deposits, 675,000 francs; withdrawals, 645,000 francs.

B: Deposits, 1,900,000 francs; withdrawals, 1,855,000 francs.

The rate of exchange on December 31, 1934, was .0675.

You find that the Paris expense payments for the year include 110,000 francs as rent for the period from January 1, 1934, to November 1, 1935; also that the French income tax for 1934 will be 60,000 francs.

Prepare entries to adjust the books of The Farewell Company, a statement of profit and loss for the year, and a balance sheet at the end of the year. Gross profits and selling prices in the United States were constant in 1933 and 1934. Do not allow the change in the exchange rate during the year to affect the branch gross profit. Convert all expenses at the average rate. Make all computations to the nearest dollar.

The management acknowledges that it is not properly accounting for its foreign business, but maintains that it is being conservative by not taking up the foreign sales until the cash is received.

QUESTIONS AND PROBLEMS ON CHAPTER 54

QUESTIONS

Question 54-1. Can you see any objections to handling the accounts of a foreign manufacturing branch as follows: When dollars are sent to the foreign factory, charge the Factory Current account with the amount of the remittance and allow the factory to take up the cash at the foreign value obtained in cashing the draft. Keep the Cash and other accounts in foreign currency only, and, when finished goods are shipped to the home office, allow the home office to convert the finished goods from the cost, as shown by the factory's books, to dollars, at the rate current at the time of receiving the goods.

Question 54-2. Is there any reason why current liabilities of a foreign factory should not be converted for balance sheet purposes at the rate current at the date of the balance sheet?

Question 54-3. Assume that a parent company sells goods to, or purchases goods from, its foreign subsidiary, payable in dollars. Explain how the parent company's and the subsidiary company's current accounts would be kept, state what exchange adjustment might be necessary at the time of settling for the goods, and explain on which set of books such exchange adjustment would be made.

Question 54-4. In the case of a foreign branch, it is advisable to keep the fixed asset accounts on the home office books. This is, of course, impossible in the case of a foreign subsidiary. How would you recommend that the subsidiary's fixed asset accounts be kept?

Question 54-5. When the foreign subsidiary's balance sheet is being consolidated with the parent company's balance sheet, how should the foreign company's Capital Stock account be converted? How should the foreign subsidiary's Surplus account be converted?

Question 54-6. Assume that the parent company follows the method of taking up its share of the foreign subsidiary's profits and recording dividends through the Investment account. How would a dollar value of such profits and dividends be determined, and what

entries would be made to record them?

Question 54-7. Assume that the parent company does not own all of the foreign subsidiary's stock. How would you determine the dollar value of the minority interest for purposes of a consolidated balance sheet?

PROBLEMS

Problem 54-1. The Pan-American Chemical Company, a New York corporation, owns a plant in Chile, in which nitrate of soda is manufactured and shipped to the United States. The accounts in Chile are kept in dollars and in the local currency (pesos). The following is a summary of the transactions during a certain year:

January 1—New York remitted by telegraphic transfer \$30,000.00, which realized 120,000 pesos.

April 1—New York remitted \$30,000.00, which realized 150,000 pesos.

July 1—New York remitted \$30,000.00, which realized 180,000 pesos.

October 1—New York remitted \$30,000.00, which realized 150,000 pesos.

Wage payments:

For plant construction, 120,000 pesos.

For operating, 300,000 pesos.

At December 31, the unpaid payroll for operating labor amounted to 60,000 pesos, and one sixth of the nitrate produced during the year remained in inventory.

You may assume that the production, construction, and shipments were distributed evenly over the twelve months, and that the only element entering into costs of production and construction in Chile was labor.

The average quoted exchange rates in Chile and New York were as follows:

Jan. 1 to June 30.....	3 pesos = \$1.00
July 1 to Dec. 31.....	5 pesos = \$1.00

At the close of business, December 31, the rate suddenly dropped to 6 pesos = \$1.00.

You are required to show the accounts on the branch books in both pesos and American dollars, and to prepare a trial balance as at December 31, for the purpose of incorporating the Chilean accounts on the New York books.

Problem 54-2. The Hull Company organized a corporation in England with £25,000 capital stock, for which it remitted at 4.70. Profits, losses, and dividends of the subsidiary have been taken up through the Investment account. Dividends received in 1933 were so taken up, but no entries were made on the parent company's books for the profits of 1933.

The following trial balances were taken from the two sets of books on December 31, 1933:

	Hull Company	England Company	
Cash.....	\$ 24,350	£ 10,000	
Accounts Receivable.....	240,000	6,000	
Intercompany Current Accounts	56,600		£ 10,800
Inventories—Dec. 31, 1932:			
Raw Materials.....	40,000		
Goods in Process.....	55,000		
Finished Goods.....	35,000	4,200	
Investment in England Co. Stk.	114,000		
Plant and Property—Net. . .	240,000	26,000	
Accounts Payable.	\$ 95,000		500
Capital Stock.....	500,000		25,000
Surplus.....	129,000	800	
Sales.....	1,010,000		80,000
Purchases.....	328,200	50,500	
Direct Labor.....	300,000		
Manufacturing Expenses	225,850		
Selling and General Expenses..	75,000	19,000	
Exchange.			200
	<u>\$1,734,000</u>	<u>\$1,734,000</u>	<u>£116,500</u>
		<u>£116,500</u>	

Inventories—December 31, 1933:

Raw Materials.	\$ 30,000	
Goods in Process.	70,000	
Finished Goods.....	42,000	£7,000

The foreign subsidiary obtains all its merchandise from the parent company, which has always billed the subsidiary at cost plus 25%, payable in dollars. Billings during 1933 amounted to \$262,600.00, which figure may be used as the basis for computing the average rate for the year. Assume the following exchange rates:

On date of acquisition of foreign plant	4 80
On December 31, 1932.....	5.12
On December 31, 1933.....	5.18

Depreciation for the year has been provided as follows:

Hull Company.....	\$40,000
England Company.....	£ 2,000

Both companies paid 6% dividends during the year.

From the foregoing data prepare:

- (1) Entries to close the subsidiary's books.
- (2) Entries to close the parent company's books.
- (3) Working papers for the preparation of the consolidated statements.

The Hull Company has followed the practice of taking profits or losses on the conversion of the subsidiary's trial balance into current operations.

Problem 54-3. In the course of an examination of the accounts of an American corporation having two foreign subsidiaries (the accounts of which are to be consolidated with those of the parent company), you are given the following comparative balance sheets of the two companies, one in Great Britain, the other in France:

GLADSTONE COMPANY

	December 31	January 1
Assets		
Current Assets	£27,000	£19,500
Fixed Assets*	5,000	4,500
Deferred Charges	1,000	1,000
	£33,000	£25,000
Liabilities and Net Worth		
Current Liabilities	£21,000	£ 8,000
Capital Stock	5,000	5,000
Surplus	7,000	12,000
	£33,000	£25,000

The investment in the capital stock of the British company is carried on the books of the main office at \$28,800.00, representing the dollar cost thereof at the date of incorporation. The rate of exchange on January 1 was 4.90 and on December 31, it was 5.20.

MARNE COMPANY

	December 31	January 1
Assets		
Current Assets	frs. 130,000	frs. 220,000
Fixed Assets*	550,000	475,000
	frs. 680,000	frs. 695,000
Liabilities		
Current Liabilities	frs. 40,000	frs. 90,000
Capital Stock	600,000	600,000
Surplus	40,000	5,000
	frs. 680,000	frs. 695,000

* No additions to fixed assets were made from the date of incorporation—January 1 of the current year.

The investment in the capital stock of the French company is carried on the books of the main office at \$90,000.00, representing

the dollar investment at the date of incorporation. The rate of exchange on December 31 was \$.04 and on January 1, \$.044.

The current liabilities of the British company include £2,000, and those of the French company, 15,000 francs, due to the main office at both dates.

The treasurer of the company proposes to convert each item on the December 31 balance sheet at the rate of exchange current at that date and to use these figures in preparing the consolidated balance sheet. The difference between the value at which the capital stock of the foreign subsidiaries is carried on the books of the main office and the net worth thus determined is to be thrown into Goodwill.

Criticize or justify the proposed method of handling these accounts. Explain and illustrate a preferable method, showing the differences in results.

Problem 54-4. The Products Company, Ltd., Canada, keeps its records on a nominal dollar basis, and presents the following balance sheet as at December 31, 1930:

Assets		
Cash.....		\$ 10,000.00
Accounts Receivable.....		300,000.00
Inventories.....		250,000.00
Fixed Assets (U. S. dollar cost at date of acquisition)		100,000.00
		<u>\$660,000.00</u>
Liabilities		
Notes Payable.....		\$ 15,000.00
Accounts Payable.....		150,000.00
Due to Parent Company (U. S. dollars).....		200,000.00
Capital (U. S. Dollars).....		150,000.00
Surplus:		
Beginning of year (U. S. dollars) ..	\$ 25,000.00	
Profit for year.....	<u>120,000.00</u>	<u>145,000.00</u>
		<u>\$660,000.00</u>

You are requested to convert this statement to a United States currency basis for consolidation with the parent company's balance sheet. Assume that the Canadian dollar is worth \$.80 in United States funds. Explain your treatment of each item.

The following information is available:

Accounts Receivable—all Canadian funds.

Notes Payable—all Canadian funds.

Accounts Payable—\$30,000.00 payable in Canadian funds, and \$120,000.00, in United States funds.

Inventories:

 Raw material purchased in Canadian funds..... \$ 20,000.00

Raw material purchased in United States funds...100,000.00
 Goods in process.....130,000.00

This item includes material purchased both in the United States and Canada, with all the labor performed in Canada. The total purchases for the year average, approximately, 85% from the United States and 15% from Canada. The labor cost approximates 13% of the cost of materials. No overhead is included in the inventory valuation.

Assume no intercompany profit on materials purchased from the parent company.

Problem 54-5. The Arlington Silk Mills incorporated a selling company in France, as of January 1, 1926, to take over the assets and liabilities of their Paris office. The opening balance sheet of the French Company is as follows:

Assets		
Cash.....		frs. 134,000
Accounts Receivable		680,000
Merchandise (at invoice price, plus freight charges, etc.).....		1,050,000
Furniture and Fixtures.....		40,000
		<u>frs. 1,904,000</u>
Liabilities		
Accounts Payable.....		frs. 23,800
Arlington Silk Mills—Current account.....		1,780,200
Capital Stock.....		100,000
		<u>frs. 1,904,000</u>

The exchange rate on January 1, 1926, was 3.70 cents to the franc. During the year, merchandise costing \$160,000.00 was shipped by the Arlington Silk Mills and billed at 10% above cost, and remittances amounting to 5,000,000 francs were made by the French company. The details were as follows:

<u>Merchandise Invoiced</u>		<u>Remittances</u>	
1/16.....	\$ 30,000 @ .0373	2/20.....	frs. 500,000 @ .0356
3/27.....	20,000 @ .0342	6/12.....	1,000,000 @ .0287
5/6.....	50,000 @ .0324	7/10.....	800,000 @ .0254
8/14.....	40,000 @ .0275	8/28.....	1,000,000 @ .0284
10/16.....	36,000 @ .0286	11/27.....	700,000 @ .0360
		12/12.....	1,000,000 @ .0379
	<u>\$176,000</u>		<u>frs. 5,000,000</u>

The trial balance of the French company on December 31, 1926, forwarded to the American company, appears on the following page.

Sales.....		frs. 7,730,000.00
Merchandise Purchases. frs.	5,645,581.46	
Merchandise Inventory.	1,050,000.00	
Freight Charges.....	580,000.00	
Warehouse Charges.....	213,000.00	
Salaries.....	474,000.00	
General Expenses.....	306,000.00	
Selling Expenses.....	117,000.00	
Accounts Receivable....	1,610,000.00	
Cash.....	284,000.00	
Furniture and Fixtures..	50,000.00	
Accounts Payable.....		73,800.00
Arlington Silk Mills.....		2,425,781.46
Capital Stock.....		100,000.00
	<u>frs. 10,329,581.46</u>	<u>frs. 10,329,581.46</u>

The inventory at the end of the year amounted to 1,412,000 francs, which amount included freight and other charges amounting to 140,000 francs, the exchange rate at that date being 3.90 cents to the franc.

Prepare a balance sheet and profit and loss statement, in dollars, for consolidation with the accounts of the American company, and submit the journal entries required on the books of the latter company.

QUESTIONS AND PROBLEMS ON CHAPTER 55

QUESTIONS

Question 55-1. What is the distinction between a devisee and a legatee?

Question 55-2. A will provides that a son shall be given a watch. Is this a specific legacy?

What is a demonstrative legacy? What is a residuary legacy?

Question 55-3. Define corpus and income, and state why the distinction is maintained in the accounts of a decedent's estate.

Question 55-4. When are dividends, interest, and rents treated as principal?

Question 55-5. Under what circumstances should a trustee amortize bond premiums by a charge against income, and under what circumstances should the loss of such premiums be charged against principal?

Question 55-6. What disposition should be made by a trustee of an amount received by him for the sale of the rights to subscribe to stock? Give reasons for your answer.

Question 55-7. If the decedent was engaged in an uncompleted contract at the time of death, do the profits on final completion belong to principal or income?

Question 55-8. A is a purchasing and sales factor, carrying on a foreign business. A dies on January 15. The auditor finds that orders to purchase were received prior to January 15, and were executed but not shipped until after January 15, since no steamship was in port to receive the goods. The business is to be carried on by the executor. How are the orders to be regarded with respect to the distribution between corpus and income of the estate?

Question 55-9. If a trust estate consists of wasting assets, such as mines, oil wells, or standing timber, must the trustee provide for depletion in determining the income?

Question 55-10. Should the following items be regarded as

applicable to corpus or income?

- (1) Legacies paid in cash.
- (2) Funeral expenses.
- (3) Profit or loss on sale of investment.
- (4) Cash dividend received on stock purchased by the executors.
- (5) Quarterly allowance to widow.
- (6) Cash dividend on stock left by the testator.

PROBLEMS

Problem 55-1. You are called in to assist in the preparation of the accounts of Will Wade, executor of the estate of A. D. Biggs, who died on May 12, 1934. No books have been kept, but you obtain a certified copy of the inventory of the estate, filed by the executor with the probate court, and bank statements and canceled checks evidencing his receipts and disbursements of the estate funds.

Among the receipts by the executor are the following:

May	20—Cash in bank paid to executor.....	\$4,050
	25—Dividend on XY stock, declared May 1, 1933.....	800
	27—Interest on \$30,000.00 note dated November 27, 1930.....	900
	30—Biggs' commissions for April and May, 1934.....	1,050
August	1—Sale of bonds inventoried at \$4,000.00.....	4,500
	Accrued interest thereon from April 1, 1934, at 6%...	80
	20—Dividends on Albion company stock, declared July 15, 1934:	
	Cash dividend.....	3,000
	Stock dividend.....	4,500
September	21—Sale of rights for subscription to additional XY stock.....	2,410
November	15—Sale of stallion.....	1,400
	And four-months-old colt.....	600
December	15—Profits for fiscal year ending October 31, 1934, in firm of Biggs Brothers, as per copartnership agreement....	4,000
	20—Dividend on account in closed bank.....	865

Show how these receipts should be recorded in the executor's accounts.

Problem 55-2. Jack Ford died on June 15, 1933, and A. R. Flournoy was appointed executor. The inventory contained the following items:

Bonds of Bayon Company—J. & J.—6%.....	\$50,000.00
Bonds of Dever Company—J. & D.—6%.....	10,000.00
Accrued Interest on Bonds.....	?
Stock of Founders Company—Par.....	50,000.00
Dividends Declared.....	1,000.00
Accounts Receivable.....	6,350.00
Cash.....	4,710.00

On July 8, the executor discovered a note receivable of \$4,000.00, dated March 1, 1933, bearing interest at 6%.

Cash collections were as follows:

<u>1933</u>			
July	1—Interest on Bayon Bonds.....	\$1,500.00	
July	5—Dividends.....	1,000.00	
September	1—Note Receivable.....	1,000.00	
	Interest in Full to Date.....	?	
September	5—Accounts Receivable.....	3,600.00	
December	1—Interest on Dever Bonds.....	300.00	
December	8—Accounts Receivable (no further collections possible)	1,850.00	
<u>1934</u>			
January	2—Interest on Bayon Bonds.....	1,500.00	
January	5—Dividends.....	3,000.00	
January	31—Stock of Founders Company (Par, \$5,500.00)	7,150.00	
March	1—Note and Interest in Full..	?	

Cash disbursements were as follows:

July	25—Physician's Bill.....	\$ 400.00
August	27—Funeral Expenses.....	850.00
December	20—Miscellaneous Debts.....	2,615.00
January	20—Miscellaneous Administration Expenses.....	340.00
January	31—Legacies.....	10,000.00

All income cash collections were paid over to the widow quarterly from the date of death.

Record all the foregoing facts in the executor's cash book and journal. Post to ledger accounts, and prepare a trial balance as of March 1, 1934.

Problem 55-3. The executor of the estate of Robert Mitchell has paid all debts, expenses, and special legacies in accordance with the will, and is ready, on May 31, 1933, to distribute the estate. He has funds of \$310,250.00 to divide. The following is a statement indicating the basis of division stipulated by the will, and also the amounts and dates of certain advances that are required by the will to be included in the estate, together with simple interest at 6%:

<u>Beneficiary</u>	<u>Share</u>	<u>ADVANCES</u>	
		<u>Amount</u>	<u>Date</u>
Helen Mitchell.....	$\frac{2}{5}$	\$ —	—
Edward Mitchell.....	$\frac{1}{5}$	50,000.00	June 1, 1930
Frank Mitchell.....	$\frac{1}{5}$	15,000.00	May 1, 1931
Grace B. White.....	$\frac{1}{5}$	10,000.00	December 1, 1932

Prepare a statement showing the distribution of the estate.

Problem 55-4. On January 1, 1915, B. A. Pearson came into possession of \$75,000.00 as executor of the estate of his deceased wife, Belle, whose will provided for the division of her estate equally between her two children. Pearson invested \$60,000.00 of the assets of the estate in 6% bonds, interest payable semiannually on June 30 and December 31.

On January 31, 1935, Pearson died. His executor found assets amounting to \$294,000.00, including the bonds mentioned above. The will provided that one half of his estate should go to his widow, and that the balance should be divided equally among his three children (one by his second wife).

Pearson had never made any accounting of the estate of his first wife, nor had he applied any of the assets thereof to the specific benefit of the stated beneficiaries.

Prepare a statement showing the proper distribution of the \$294,000.00 of assets found by Pearson's executors, assuming no expenses of administration and assuming also a legal requirement for the allowance of simple interest at the rate of 5% on cash funds held by Pearson and not applied in accordance with the requirements of his first wife's will.

QUESTIONS AND PROBLEMS ON CHAPTER 56

QUESTIONS

Question 56-1. If the same person is both executor and trustee, what distinction should be made between his records as executor and as trustee?

Question 56-2. Explain the method of closing the books of an executor, showing the final distribution of the estate.

Question 56-3. State three rules that have been applied in different states for the classification of stock dividends as between principal and income.

Question 56-4. Name the various classes of items that might appear in a charge and discharge statement as to principal.

Name the various classes of items that might appear in a charge and discharge statement as to income.

Question 56-5. What is the difference between an executor's intermediate and final account?

Question 56-6. The estate of Samuel J. Henderson contains fifty shares of First National Bank stock of \$100 par value each. This stock is carried on the trustee's books at \$550.00 per share, or a total of \$27,500.00. In accordance with its regular custom the bank paid a dividend of 12% on March 1, 1934. The dividend was paid in cash, but the bank gave its stockholders the option of buying new stock at par, to the amount of the dividend. The trustees indorsed and returned the dividend check, receiving in exchange six shares of new stock. How should this transaction affect the interests of the life tenants and the remainderman?

PROBLEMS

Problem 56-1. The following trial balance was taken on December 31, 1933, from the books of Howard Webster, executor of the estate of Charles Jamison, who died on May 9, 1933.

Prepare the executor's charge and discharge statements (without supporting schedules), and make the journal entries required to close the books.

Bonds	\$25,000.00	
Stock	20,000.00	
Loss on Realization	575.00	
Gain on Realization		\$ 635.00
Funeral and Administration Expense ..	1,630.00	
Debts of Decedent	2,315.00	
Legacy—Fred Burns	5,000.00	
Income		2,250.00
Expense—Income	460.00	
Distributions of Income Cash	1,000.00	
Cash—Income	790.00	
Cash—Principal	6,710.00	
Estate Corpus		56,970.00
Assets Not Inventoried		3,625.00
	<u>\$63,480.00</u>	<u>\$63,480.00</u>

Problem 56-2. John Smith died on January 15, 1933, and in his will named Richard Wells as executor. The will provided that a legacy of \$3,000.00 be paid to Mary Smith, sister of the testator, and that, after payment of all debts, the residuary estate be divided equally between the testator's wife and son.

The estate consisted of the following:

Cash in bank	\$ 948.50
One month's salary due from employer	500.00
Ten Union Company 6% bonds	10,000.00
One income bond, Central Corporation	1,000.00
Demand note of Walter Hays	1,000.00

At his death the testator owed:

Two months' rent	\$250.00
Dr. Mayer	481.75

The executor received \$948.50 from the bank, with \$21.25 interest. He sold the Union Company bonds at 104 and four months' interest; the income bond, for \$510.00 flat; and paid \$390.00 for funeral expenses, \$185.00, for mourning apparel, and \$265.00, for legal and other expenses. Walter Hays was bankrupt, and his note proved to be worthless.

The executor deducted his commission of \$200.00, and distributed the funds of the estate according to the terms of the will.

Prepare a charge and discharge statement.

Problem 56-3. A dies on March 7, 1933, leaving an estate consisting of the following property:

Cash in bank	\$ 6,245.00
Accounts receivable	45,000.00
Real estate, unimproved, valued at	17,000.00

	<u>Par</u>	<u>Market</u>
Bank stock.....	\$10,000.00	\$18,350.00
Mining stock.....	15,000.00	12,000.00
Railway bonds, 4%, J. & J.....	12,000.00	11,050.00
Municipal bonds, 3½%, F. & A.....	20,000.00	20,450.00

Three of his heirs are indebted to him for money loaned:

<i>C</i>	\$8,000.00
<i>D</i>	6,000.00
<i>E</i>	4,500.00

The will directs the executors to convert the assets and distribute the funds in the following manner:

	<u>Principal</u>	<u>Income</u>
<i>B</i> (Widow)....	2/5	all
<i>C</i>	1/5	
<i>D</i>	1/5	
<i>E</i>	1/5	

The bank stock is sold at \$225.00, and the mining stock, at 73½¢, both sales taking place on August 15, 1933.

The municipal bonds are sold on November 20, 1933, at 103⅞ and accrued interest.

The real estate is sold on December 10, 1933, for \$4,000.00 in cash and a 6% mortgage of \$10,000.00.

The railway bonds mature on January 1, 1934.

On April 30, 1934, the accounts receivable are finally collected, with losses and expenses amounting to \$1,385.00, and the mortgage is sold at 97 and accrued interest.

Interest received on bank balances, \$200.00; dividends received, \$460.00.

The executors pay the decedent's debts and funeral expenses, \$1,400.00; counsel fees, \$550.00; advances to *B*, \$850.00; safe deposit rent, \$25.00; office expenses incident to collection of income, \$400.00. The executors wind up the estate on May 1, 1934, and are allowed a fee of \$1,200.00, \$250 of which is chargeable to income.

Prepare the charge and discharge statements and the executors' cash book. Show the distribution of the cash.

In computing accrued interest, use the 360-day year and the actual number of days.

Problem 56-4. A. O. Forbes, executor of the estate of Will Hoyne, who died on May 15, 1933, asks you to prepare statements for him to render to the court as of July 31, 1934, using the following information:

The cash on hand and in bank on May 15, 1933, was \$2,500.00.

The estate contained certain real estate which the will ordered sold. It was inventoried at \$17,000.00, and sold on August 1, 1933; the executor received \$6,000.00 in cash and a mortgage for \$10,000.00, bearing interest at 6% per annum, payable semiannually; all interest was collected when due. The mortgage was sold on May 1, 1934, at 102 and accrued interest.

Accounts receivable of \$17,250.00 were collected in full; two accounts of \$500.00 each proved worthless.

Notes receivable and collections thereon were as follows:

<u>Maker</u>	<u>Principal</u>	<u>Interest Accrued May 15, 1933</u>	<u>Total Collected</u>
Frank Poor.....	\$ 4,000.00	\$220 00	\$ 4,400.00
James Timm.....	10,000.00	100.00	10,300.00
L. D. Ways.....	<u>8,000.00</u>	<u>50.00</u>	<u>5,500.00</u>

No further collections are expected.

Securities owned:

Playfair Corporation, 6's, J. & J., \$20,000.00 par value; inventoried at 98; matured July 1, 1934.

Barber Company, 6's, M. & S., \$12,000.00 par value; inventoried at par; called for redemption on March 1, 1934, at 103.

Becker Brothers, 7% Prior Preferred, 150 shares; inventoried at par (\$15,000.00); dividend of 6%, declared May 1 of each year, payable May 20; sold May 8, 1934, at 107 and declared dividend.

The executor paid the decedent's debts and funeral expenses, \$2,580.00; attorney's fees, \$800.00; expenses of general administration, \$200.00; legacies of \$8,500.00; and executor's fee, \$1,000.00, apportionable equally to income and principal.

The estate was divided on July 31, 1934, the widow receiving all of the net income and one third of the principal, and three children, Helen, Jack, and Leon, each receiving two ninths of the principal. In the division of the estate, consideration was given to advances made to the children during the decedent's life, in the respective amounts of \$8,000.00, \$4,500.00, and \$10,500.00.

Problem 56-5. Frank Healy dies on May 15, 1933, leaving a will in which he instructs his executor to:

- (1) Use his best judgment in the disposition of such assets as may be necessary to liquidate all his liabilities.
- (2) Pay his widow, Martha, an allowance out of income at the

rate of \$1,250.00 per month, from the date of his death to the date of the distribution of the residue of his estate.

- (3) Distribute the residue of his estate, after all claims and legacies have been met, as follows: one half to his widow, and one half to certain trustees named in the will.

The executor draws up the following inventory of the estate, at appraised values:

Real Estate.....	\$260,000.00
Corporation Stock.....	340,000.00
Bonds.....	390,510.00
Loans.....	25,650.00
Land Contracts.....	60,500.00
Cash.....	45,000.00
Accrued Interest Receivable.....	5,810.00

From the date of death to October 15, 1934, the cash receipts are:

- 80 Bonds, par \$1,000.00, inventoried at 105, sold at 102¾.
- 500 shares of stock, par \$100.00, inventoried at 60, sold at 80.
- 400 shares of stock, par \$50.00, inventoried at 70, sold at 86½.
- Real estate, inventoried at \$45,000.00, and encumbered by a mortgage of \$30,000.00, sold by consent of the probate court and the widow for a sum \$25,000.00 in excess of the mortgage, the purchaser assuming the mortgage.
- Dividends, \$19,000.00.
- Interest, \$27,900.00.
- Net rental income, \$20,650.00.
- Loans, \$18,465.00.

Cash disbursements are:

- Bills payable, \$130.00.00.
- Accounts payable, \$1,200.00.
- Funeral expenses, \$1,800.00.
- Interest (of which \$1,200.00 was accrued at death), \$5,750.00.
- Office expense (\$4,000.00 against principal), \$7,000.00.
- Executor's fee (\$10,000.00 against principal), \$12,500.00.
- Legacies, \$50,000.00.
- Payments to widow out of income, \$22,500.00.

The accrued interest on October 15, 1934, totals \$3,150.00.

Prepare journal entries recording the foregoing facts, the closing of the books, and the distribution of the estate on October 15, 1934. Prepare statements for submission to the court.

PROBLEMS ON CHAPTER 57

Problem 57-1. You are called, during January 1934, to assist the officials of the Morning Company in the preparation of a budget for the current year. The statements of the company for the first year of its operations appear on the following pages.

In addition to the accompanying statements, you are given the following data relative to the estimates for 1934:

Sales: Sales prices have been reduced one eighth, and a 60% increase in quantity volume is expected. Sales are uniform throughout the year.

Collections: It is estimated that the accounts receivable on the books at the end of 1933 will be disposed of as follows: an amount equal to the present reserve will be written off, and the remainder will be collected. Collections, discounts, bad debt provisions, and write-offs during 1934 may be estimated on the basis of 1933 experience.

Production: The production during 1934 must be increased to take care of the increased sales, and also to provide for a finished goods inventory at the end of 1934, equal to the sales requirements for one and one-half months. Production will be uniform throughout the year.

Materials: Material prices will be reduced 10% by purchasing from a different supplier, but freight rates will be increased 20%. The inventory at the end of the year is to be equal to one month's production requirements. Purchases from the proposed new supplier will be paid sixty days after billing, less 1%. Freight will be paid in the month of purchase.

Accounts payable to the former supplier will be paid less 3% discount.

Direct and Indirect Labor: All factory wages and salaries were increased 5%, effective January 1, 1934. Direct labor varies with volume. Half of the indirect labor is fixed, and the remainder varies with the quantity of production. Labor costs for one-half month will be unpaid at the end of the year.

Other Manufacturing Costs: License fees are fixed. An appropriation of \$32,560.00 has been made for 1934 experimental expense.

Balance Sheet—December 31, 1933

Assets		
Current Assets:		
Cash.....		\$ 48,800
Accounts Receivable.....	\$540,000	
Less Reserve for Bad Debts.....	36,000	504,000
Inventories:		
Finished Goods.....	\$ 90,000	
Raw Materials.....	91,800	181,800
Total Current Assets.....		\$ 734,600
Deferred Charges:		
Advances to Salesmen.....	\$ 16,000	
Factory Supplies.....	18,700	
Total Deferred Charges.....		34,700
Fixed Assets:		
Land.....	\$ 69,500	
Buildings.....	150,000	
Machinery and Equipment.....	260,000	
Furniture and Fixtures.....	50,000	
Total.....	\$460,000	
Reserve for Depreciation.....	20,000	440,000
Total Fixed Assets.....		509,500
Goodwill.....		60,000
		<u>\$1,338,800</u>
Liabilities and Net Worth		
Current Liabilities:		
Bank Loans—6%.....	\$180,000	
Accounts Payable—Materials.....	150,000	
Accrued Factory Wages—Indirect.....	7,500	
Reserve for 1933 Property and Income Taxes.....	33,300	
Total Current Liabilities.....		\$ 370,800
Mortgage Payable—5%—Due June 30, 1947.....		275,000
Net Worth:		
Preferred Stock—7%.....	\$200,000	
Common Stock.....	400,000	
Surplus.....	93,000	
Total Net Worth.....		693,000
		<u>\$1,338,800</u>

Depreciation rates are: buildings, 6%; machinery and furniture, 10%; one half of the annual rates are used for additions (see below). Other items vary with output, after \$7,300.00 of the non-recurring expenses included under Miscellaneous has been eliminated. All manufacturing expenses except taxes will be paid during the year. Deferred charges for factory supplies will increase to \$22,000.00.

Selling Expenses: Salaries are fixed; commissions are based on sales; effective January 1, 1934, salesmen are to be allowed a group bonus (payable after the close of the year) of 5% on annual sales in excess of \$3,500,000.00. The 1934 advertising appropriation is \$250,000.00. The foregoing items, except the bonus, and

Profit and Loss Statement
Year Ended December 31, 1933

Sales	\$3,000,000.00
Cost of Goods Sold	<u>1,800,000.00</u>
Gross Profit on Sales	\$1,200,000.00
Selling Expenses:	
Salaries	\$ 85,000.00
Commissions	135,000.00
Advertising	310,000.00
Branch Office Expense	40,000.00
Traveling	30,000.00
Miscellaneous	<u>38,000.00</u>
Total Selling Expenses	638,000.00
Net Profit on Sales	\$ 562,000.00
Administrative Expenses:	
Officers' Salaries	\$150,000.00
Office Salaries	77,500.00
Office Supplies and Expenses	42,500.00
Bad Debts	60,000.00
Corporate Taxes	11,000.00
Depreciation	2,500.00
Miscellaneous	<u>22,500.00</u>
Total Administrative Expenses	366,000.00
Net Profit on Operations	\$ 196,000.00
Net Financial Expense:	
Interest Expense	\$ 25,580.00
Discount on Sales	48,720.00
Total	\$ 74,300.00
Less Discount on Purchases	<u>24,800.00</u>
Net Financial Expense	49,500.00
Net Income Before Federal Income Tax	\$ 146,500.00
Federal Income Tax	<u>18,300.00</u>
Net Income	<u>\$ 128,200.00</u>

December commissions, will be paid in full during the year, partly in cash and partly by complete application of the advances to salesmen; similar advances will be discontinued in 1934. Other selling expenses (of which 95% will be paid during the year) vary with the quantity of sales volume, after the following non-recurring items have been excluded:

Branch office expense	\$10,000.00
Traveling	8,000.00
Miscellaneous	15,000.00

Beginning January 1, 1934, the company's sales are subject to a 2% state sales tax; each month's accrual of this tax is payable in the following month.

Administrative Expenses: Officers' salaries are fixed; bad debts and depreciation are to be computed on the same basis as in 1933;

Statement of Cost of Goods Sold
Year Ended December 31, 1933

Materials:	
Purchases.....	\$900,000.00
Freight In.....	18,000.00
Total.....	<u>\$918,000.00</u>
Less Inventory—December 31.....	<u>91,800.00</u>
Materials Used.....	\$ 826,200.00
Direct Labor.....	528,000.00
Manufacturing Expenses:	
Indirect Labor and Supervision.....	\$180,000.00
License Fees.....	100,000.00
Experimental Expense.....	37,500.00
Power and Light.....	30,000.00
Small Tools and Supplies.....	52,500.00
Depreciation.....	17,500.00
Insurance and Building Expense.....	21,000.00
Taxes.....	15,000.00
Repairs.....	24,000.00
Spoilage.....	6,000.00
Miscellaneous.....	<u>52,300.00</u>
Total Manufacturing Expenses.....	<u>535,800.00</u>
Total Cost.....	\$1,890,000.00
Less Inventory of Finished Goods—December 31.....	90,000.00
Cost of Goods Sold.....	<u><u>\$1,800,000.00</u></u>

other expenses will increase 10%, after \$8,000.00 of the organization expense included in Miscellaneous is eliminated. Five per cent of office supplies and expenses and miscellaneous expenses will be unpaid at the end of the year.

Additions to Fixed Assets: Contracts have been entered into for a new factory building to cost \$80,000.00 and additional machinery therefor to cost \$100,000.00. The building contractor and the machinery supplier have agreed to take, in payment, the company's ten-year 6% mortgage notes, dated April 1, 1934, at 90. Interest on these notes is payable semiannually.

Financial Expenses: The company's bank loan requirements are expected to average \$300,000.00 during the year. In order to improve its working capital ratio, the company, at the end of the year, will make the largest possible payment in reduction of the bank loan; the payment will be an amount equally divisible by \$5,000.00, and the bank requires that the amount kept on deposit be not less than 25% of the loan.

Federal Income Tax: The rate for 1934 is 13 $\frac{3}{4}$ %.

Dividend Payments: The full dividend requirement on the preferred stock is to be paid, and dividends up to 7 $\frac{1}{2}$ % will be paid on the common stock if the earnings are sufficient.

Prepare estimated operating statements and a balance sheet. Make all computations to the nearest dollar.

Problem 57-2. X desires to engage in business as a retail distributor of refrigerators, which he proposes to market on an installment basis. The refrigerators will be sold for \$150.00 each; \$15.00 will be collected at the time of sale, and the balance of the sale price will be collected in nine monthly installments of \$15.00.

X can obtain the refrigerators on a consignment basis, under an agreement to remit at the end of each month, at the rate of \$90.00 each, for all refrigerators sold during the month. Salesmen are to be allowed a 20% commission, payable at the end of the month of sale. Overhead expenses are estimated at \$26,400.00, and interest, credit, and collection expenses, at \$12,000.00. (For purposes of this problem, it may be assumed that these expenses will be incurred in equal monthly amounts, payable at the end of the month.) Recoveries and repossessions are expected to offset losses on bad accounts.

X budgets his first year's sales as follows:

	<u>Units</u>		<u>Units</u>
January.....	75	July.....	300
February.....	125	August.....	200
March.....	150	September.....	150
April.....	200	October.....	100
May.....	400	November.....	75
June.....	400	December.....	150

X does not have sufficient capital to finance his business, and he carries his plans to his banker. The bank extends X a line of credit, secured by a pledge of his entire accounts receivable, on the following basis:

(1) At the end of each month the bank will honor a draft drawn by the manufacturer in any amount up to 60% of X's accounts receivable at that date.

(2) X is to maintain at all times a bank balance of not less than 15% of his bank loan, with a minimum of \$5,000.00.

(3) On January 1, X is to invest in the business the maximum amount of cash he will require (in addition to the bank loan) at the peak point of the year, and is to make no withdrawals of this capital during the year.

(4) Borrowings from, and repayments to, the bank are to be made in units of \$1,000.00.

Compute the amount of X's initial investment, to the nearest thousand dollars, and make a schedule of monthly borrowings and repayments.

Problem 57-3. You are engaged by Cavanaugh Company to prepare a forecast of its operations for the period from April 1 to

July 31, 1934. From the information given, prepare a monthly cash statement, a monthly income and expense statement in columnar form, and a balance sheet as of July 31, 1934.

Balance Sheet—March 31, 1934

Assets	
Cash on Deposit.....	\$ 24,820.00
Accounts Receivable.....	69,600.00
Inventory of Raw Material.....	27,000.00
Buildings, Machinery, and Equipment.....	135,000.00
Prepaid Insurance.....	3,300.00
	<u>\$259,720.00</u>
Liabilities and Net Worth	
Note Payable (special 6% loan).....	\$ 30,000.00
Accounts Payable.....	51,850.00
Accrued Pay Roll.....	11,950.00
Accrued Interest and Taxes.....	3,300.00
Depreciation Reserve.....	2,700.00
Capital Stock.....	150,000.00
Surplus.....	9,920.00
	<u>\$259,720.00</u>

Income and Expense—Three Months Ended March 31, 1934

Sales.....	\$180,000.00
Material Consumed.....	\$60,000.00
Direct Labor.....	36,000.00
Overhead.....	36,000.00
	<u>132,000.00</u>
	\$ 48,000.00
Administrative Expense.....	\$15,000.00
Selling Expense.....	9,000.00
	<u>24,000.00</u>
	\$ 24,000.00
Cash Discounts.....	\$ 1,080.00
Depreciation.....	2,700.00
Interest.....	300.00
	<u>4,080.00</u>
Net Profit.....	\$ 19,920.00
Organization Expense.....	10,000.00
Surplus.....	<u>\$ 9,920.00</u>

All buildings and equipment are used in manufacturing. In July, \$15,000.00 of new machinery will be purchased. Depreciation charges will be as follows: April, May, and June, \$1,000.00 each; July, \$1,060.00.

Thirty per cent of sales are collected during the month of shipment and are allowed 2% cash discount; 60% are collected during the following month; 8%, in the next month; and the balance may be considered uncollectible.

Accounts payable for all purchases and expenses, including administrative and selling, are due on the 10th of the following month. Pay rolls are payable on the 5th and 20th of each month

for preceding half calendar-month periods.

Cavanaugh Company's credit permits loans in multiples of \$5,000.00 for full calendar-months only, with interest deducted at 6% per annum. In computing monthly cash requirements, you may disregard the actual date of receipts and disbursements and consider that the full month's receipts are available to apply on the disbursements of the same month.

The special term note outstanding March 31 is dated February 1, due in four months.

The following summary shows actual sales and production for the first three months of the year and estimated sales and production for the succeeding five months:

	UNITS	
	Sales	Production
January (actual).....	10,000	10,000
February ".....	20,000	20,000
March ".....	30,000	30,000
April.....	20,000	30,000
May.....	25,000	40,000
June.....	30,000	35,000
July.....	65,000	60,000
August.....	50,000	50,000

Cost of finished product sold should be based on the average of the opening inventory and the current month's production costs. It is expected that the selling price of \$3.00 a unit can be maintained and that selling expense will retain a fixed relation to sales. Administrative expenses will remain unchanged during the period covered by your investigation.

Direct labor and material costs have a constant relation to production. Overhead expenses are at a minimum of \$10,000.00 a month when production is at 10,000 units or less, and increase with production at the rate of \$1.00 for each \$3.00 expended for direct labor. Fifty per cent of such expenses consists of indirect labor and fixed monthly charges for insurance and taxes, and 50% comprises various other manufacturing expenses, exclusive of depreciation.

Insurance was taken out on January 1, for three years, at a cost of \$3,600.00. Taxes of \$12,000.00 per annum are payable June 20 and December 20 for current semiannual periods.

It is desired that a raw materials inventory sufficient only for the following month's requirements be maintained throughout the period.

At a directors' meeting to be held during April, a dividend of 10% will be declared, payable May 15.

Income taxes may be disregarded.

Problem 57-4. In January 1934, the Northern Oil Company prepared a budget covering the six months from January 1 to June 30, 1934, the main purpose being an endeavor to forecast the company's *cash position* as of June 30, 1934.

The figures used in compiling the budget and the actual figures for the six months are given below.

From these and the data following, you are required to prepare a statement for presentation to the board of directors, showing a comparison between estimated and actual results and, in addition, a brief but comprehensive report, to be read in conjunction with the statement, explaining the differences.

The figures given below cover all sources of revenue and expense. Cash on hand on January 1, 1934, is \$310,500.00.

NORTHERN OIL COMPANY

	<u>Estimated</u>	<u>Actual</u>
Sales of Crude Oil.....	\$4,000,000.00	\$3,610,000.00
Sales of Refined Products:		
Gasoline.....	4,400,000.00	4,200,000.00
Kerosene.....	420,000.00	406,000.00
Others.....	1,555,200.00	1,580,400.00
Purchases of Refined Products:		
Gasoline.....	315,000.00	380,000.00
Others.....		102,000.00
Operating Expenses:		
Direct Charges.....	1,620,000.00	1,560,000.00
Materials and Supplies from Warehouses...	180,000.00	170,000.00
Marketing Expenses.....	2,290,400.00	2,222,240.00
General and Administrative Expenses.....	900,000.00	800,000.00
Capital Additions:		
Direct Charges.....	2,000,000.00	1,800,000.00
Materials and Supplies from Warehouses...	1,500,000.00	1,500,000.00
Interest on Bonds.....	60,000.00	60,000.00
Bond Sinking Fund.....	50,000.00	50,000.00
Preferred Stock Dividend.....	350,000.00	350,000.00
Preferred Stock Sinking Fund.....	200,000.00	200,000.00
Accounts Receivable:		
January 1.....	900,000.00	900,000.00
June 30.....	1,200,000.00	1,100,000.00
Accounts Payable:		
January 1.....	700,000.00	700,000.00
June 30.....	800,000.00	750,000.00
Inventories of Materials and Supplies:		
For Operating Purposes, January 1.....	50,000.00	50,000.00
For Operating Purposes, June 30.....	50,000.00	50,000.00
For New Construction, January 1.....	500,000.00	500,000.00
For New Construction, June 30.....	500,000.00	400,000.00

There are no marketing expenses on crude oil sales.

Purchases of materials and supplies are paid for within the month received.

Statement of Quantities

	<u>Purchases</u>	<u>Production</u>	<u>Sales</u>
Crude Oil (Barrels):			
Estimated		4,000,000	2,000,000
Actual		3,800,000	1,900,000
Refined Products (Gallons):			
Gasoline:			
Estimated	3,000,000	50,400,000	40,000,000
Actual	4,000,000	47,880,000	42,000,000
Kerosene:			
Estimated		8,400,000	6,000,000
Actual		7,980,000	5,800,000
Others:			
Estimated		21,000,000	19,440,000
Actual	1,200,000	19,950,000	17,560,000
Refinery Loss:			
Estimated		4,200,000	

Note: 1 barrel equals 42 gallons.

QUESTIONS AND PROBLEMS ON CHAPTER 58

QUESTIONS

Question 58-1. A municipality obtained a tax levy as follows:

	<u>Mills</u>
For General Fund purposes.....	8.44
For Sinking Fund purposes.....	4.9
Total..	<u>13.34</u>

On the basis of this levy, \$25,000.00 was collected during a certain month of the fiscal year. What part of this \$25,000.00 belongs to the General Fund and what part to the Sinking Fund?

Question 58-2. A municipality derives its revenue from taxation. The valuation of its assessable property is as follows:

Real Property.....	\$40,350,000.00	
Personal Property.....	<u>4,100,000.00</u>	
Total Valuation.....		\$44,450,000.00

The estimated expenses for 1935 are as follows:

Police Department.....	\$96,975.00	
Fire Department.....	96,000.00	
Street Department.....	48,500.00	
Sewer Department.....	39,400.00	
Health Department.....	15,000.00	
Other Departments.....	<u>37,500.00</u>	
Total.....		\$333,375.00

In addition to meeting these expenses, the city must provide for the interest on its bond debt of \$1,333,350.00, which bears 5%; and must, according to the stipulation in its charter, levy one half of a mill tax for each park and library, and one mill tax for a sinking fund for the redemption of its bonds.

Prepare a statement giving the tax levy in mills and amounts necessary to produce sufficient money for the following funds:

General Fund.
Interest Fund.
Park Fund.
Library Fund.
Sinking Fund.

Question 58-3. A municipality sells its bond issue of \$100,000.00 for water works purposes, receiving par, 2% premium, and \$500.00 accrued interest. How much of the proceeds can the municipality use for water works purposes? Give reasons for your answer.

Question 58-4. In auditing the accounts of the city of Cook, the following balance sheet under the heading of Capital Fund was submitted to you for verification:

Cash.....	\$	5,000.00	Vouchers Payable...	\$	1,000.00
Properties		2,500,000.00	Capital Surplus.....		1,504,000.00
			Funded Debt		1,000,000.00
		<u>\$2,505,000.00</u>			<u>\$2,505,000.00</u>

You find that \$25,000.00 of the funded debt was incurred on account of a current deficit.

Prepare a corrected statement for use in your audit report.

Question 58-5. In auditing the annual report of the town of *X*, you find all the following items of receipts stated under the general heading of "Revenues":

1. Taxes received.
2. Loan from Bank of *X*.
3. Dog licenses.
4. Municipal court fines.
5. Bequest from the estate of *A* to establish town library.
6. Street assessments collected from owners of property.
7. Permits for parades.
8. Sale of worn-out equipment.
9. State grant for upkeep of a state highway within town limits.
10. Deposit by *B* to cover cost of extra sewer connection.
11. Interest on bank deposits.
12. Donation from *C* toward repairs on his street.
13. Annual payment under franchise by *X* Street Railway Co.
14. Fees turned in by town clerk.
15. Rent of city dock to steamboat company.
16. Assessments on members of police force for pension fund.
17. Received from *B*: balance of cost of extra sewer connection (see 10).
18. Newsstand privilege in city hall.
19. Proceeds of paving bonds sold at 110.

Restate these items to show true revenues of the town, and indicate how the other items should be shown or treated.

Question 58-6. The town of X erects a school building from the proceeds of bonds issued for the purpose. It is estimated that the building will last twenty years. The bonds also mature in twenty years and contain a sinking fund clause to provide the funds for their payment at maturity. The school board makes no provision for depreciation on the building in the annual tax rate, and a controversy arises in the town as to whether such a provision should be made. Discuss briefly both sides of this question.

PROBLEMS

Problem 58-1. In the city of X, a tax levy for a special fund was made on January 1, 1933, in the amount of \$1,314,435.00. The receipts for this purpose to June 30 totaled \$821,943.00, which sum was the balance in the fund on July 1. Receipts for the succeeding months were as follows: July, \$286,842.00; August, \$52,137.00; September, \$38,441.00; October, \$33,333.00; and November, \$2.00. The November receipts were the final possible collections from this levy.

An appropriation of \$1,250,000.00 was made on July 1 from this fund, and vouchers were certified against the appropriation and warrants issued as follows: July, \$89,377.00; August, \$95,574.00; September, \$120,841.00; and October, \$133,358.00.

During the month of November vouchers were certified to the amount of \$160,581.00, for which warrants were issued to the amount of \$117,193.00.

The total amount of warrants paid by the treasurer during the five months ending November 30 was \$474,059.00; no warrants were outstanding on July 1.

Set up a statement of the accounts of the special fund, and a balance sheet of the fund as of November 30.

Problem 58-2. The council of Lake City drew up the following budget for the fiscal year 1934-35:

Appropriations.....	\$300,000.00
Estimated miscellaneous revenues.....	30,000.00
Required to be raised by taxation.....	<u>\$270,000.00</u>

The current year's tax levy, for the first time, was made at a rate which permitted the establishment of a reserve (10%) for uncollectible taxes. On June 30, 1935, the reserve for taxes is to be adjusted to 50% of the current year's taxes uncollected, and all prior years' taxes uncollected (\$4,000.00) are to be charged off.

When specific appropriations are approved, it is the city's practice to draw up warrants and register them with the county treasurer; upon receipt of audited invoices, the warrants are issued. Warrants registered during the current year total \$290,000.00.

Interest on warrants is not covered by the appropriations.
On June 30, 1935, the city's Cash account appears as follows:

Balance—June 30, 1934.....		\$ 6,000.00	
Receipts:			
Current year's taxes.....	\$250,000.00		
Miscellaneous revenues.....	35,000.00		
Prior years' taxes.....	15,000.00		
Interest thereon.....	1,500.00	301,500.00	
Total.....			\$307,500.00
Disbursements:			
Current year's warrants paid.....	\$280,000.00		
Interest thereon.....	1,000.00		
Prior years' warrants paid.....	18,000.00	299,000.00	
Cash balance, June 30, 1935.....			<u>\$ 8,500.00</u>

Prepare a statement of accounts for the year; a balance sheet—June 30, 1935; and a statement of revenues and surplus for the year and a comparison with the budget.

Problem 58-3. Your examination of the accounts of the Smith-town Home for Children discloses the following:

The home was founded on January 1, 1930, by two men who made contributions as follows: mortgages, \$100,000.00; bonds valued at \$200,000.00; land valued at \$75,000.00; buildings and equipment valued at \$120,000.00; and cash, \$20,000.00 for general purposes.

According to the trustees' minutes, the following funds were established: Smith endowment fund, \$150,000.00, and Taylor endowment fund, \$150,000.00, representing investments in mortgages and bonds, the income therefrom to be used for general purposes; property and equipment fund, representing the property and equipment of the institution; and general fund, representing the general funds of the institution.

The following transactions were recorded in the cash book during the three months ended March 31, 1930:

Receipts:			
Original contribution for general purposes.....	\$20,000.00		
Mortgage principal.....	10,000.00		
Donation for improvements to buildings.....	15,000.00		
Donation for painting and repairs to buildings....	5,000.00		
Bond interest.....	2,500.00		
Mortgage interest.....	2,500.00		
Board and maintenance of children.....	5,000.00	\$60,000.00	
Payments:			
Ice plant.....	\$ 5,000.00		
Petty cash fund.....	100.00		
Board and maintenance of children.....	17,900.00		
General and administrative expenses.....	2,000.00	25,000.00	
Balance—March 31, 1930.....			<u>\$35,000.00</u>

At March 31, 1930, bond interest due and uncollected amounted to \$500.00; uncollected charges for board and maintenance of children, \$6,000.00; and unpaid bills for general expenses, \$500.00, and for board and maintenance of children, \$500.00.

In accordance with the above information, prepare a balance sheet as at March 31, 1930, and a statement of income collectible and expenditures for the three months ended that date.

Problem 58-4. On December 31, 1929, the trial balance of the Hospital for Incurables was as follows:

Accrued Wages, Household.....		\$	1,431
Accrued Wages, Nurses			2,088
Ambulance Expenses	\$	11,540	
Ambulance Revenue.....			12,565
Audited Vouchers. +.....			42,510
Bonds Owned, Endowment	506,090		
Bonds Purchased, Endowment	22,500		
Building Fund, Principal.....			177,010
Building Fund, Income.....			29,150
Cash in Bank, General Fund..	4,449		
Cash in Bank, Endowment Fund.....	4,341		
Cash in Bank, Building Fund.....	7,315		
Certificate of Deposit, Building Fund.....	23,000		
Commonwealth of Pennsylvania.....			45,000
Construction in Progress.....	77,490		
Contributions, Current.....			5,507
Contributions, Deficit.....			17,560
Certificate of Deposit Matured..			5,000
Deficit, 1928.....	27,510		
Drug Sales.....			26,114
Drug Purchases.....	18,110		
Endowment Fund, Principal.....			795,064
Guaranteed Mortgages, Endowment.....	187,000		
General Expenses (including ground rent).....	32,176		
General Fund, Principal.....			583,236
Ground Rents, Endowment.....	900		
Ground Rent Payable, Hospital Land.....			6,000
Heat, Light, and Power.....	24,220		
Hospital Buildings.....	347,310		
Hospital Equipment.....	197,600		
Hospital Insurance.....	540		
Hospital Land.....	60,000		
Hospital Supplies.....	51,710		
Improvements, Foreclosed Real Estate.....	286		
Income from Endowment Fund.....			40,000
Income to General Fund.....	40,000		
Interest on Bonds, Endowment.....			27,650
Interest on Certificate of Deposit.....			485
Interest on Guaranteed Mortgages.....			8,745
Interest on U. S. Treasury Notes.....			5,950
Inventories of Drugs.....	6,570		
Laundry.....	25,612		

Loan Payable to Building Fund.....		\$ 40,000
Loan Payable to Endowment Fund.....		62,500
Loan Receivable from General Fund—January 1, 1929	\$ 40,000	
Loan Receivable from Building Fund—July 1, 1929..	62,500	
Maintenance and Repairs, Hospital.....	40,294	
New Roof—Out-Patient Building.....	1,610	
Operating Room.....		16,410
Out-patient Department.....		26,751
Pay Patients' Accounts.....	13,513	
Patients' Deposits.....		1,750
Petty Cash.....	1,200	
Plumbing Alterations, Ward C.....	8,762	
Prepaid Insurance, Hospital.....	7,172	
Private Rooms.....		131,710
Real Estate, Endowment Fund, Mortgage Foreclosed	8,926	
Reserve for Replacements.....		17,650
Rents Received, Foreclosed Real Estate..		1,290
Repairs to Foreclosed Real Estate.....	57	
Safe Deposit Box, Endowment Fund.....	15	
Salaries.....	9,399	
Securities of Doubtful Value, Endowment Fund....	7	
Subscriptions Collected.....		45,710
Subscriptions Receivable, Building Fund.....	83,000	
Taxes, Foreclosed Real Estate.....	127	
Telephone Revenue.....		265
Unclaimed Wages.....		187
U. S. Treasury Notes, Building Fund.....	95,000	
Wages, Buildings, and Grounds.....	21,707	
Wages, Household.....	87,065	
Wages, Nurses.....	110,840	
Wages, Other.....	9,270	
Ward Patients.....		92,685
X-Ray.....		8,760
	<u>\$2,276,733</u>	<u>\$2,276,733</u>

Only cash transactions have been recorded since the books were adjusted on December 31, 1928. In addition, you find that:

1. The minutes state that:

- (a) All loans between funds shall pay 6% interest.
- (b) This interest must be cleared every year.
- (c) The appropriation granted by the Commonwealth of Pennsylvania for the year 1929 is \$60,000.00.
- (d) The bequest "for endowment" from the estate of A, deceased, received in bonds, and accepted and acknowledged, is \$75,000.00.
- (e) The usual allowance of \$15,000.00 for replacements in lieu of depreciation is to be made.
- (f) Efforts are to be made to remove any deficits by obtaining special contributions for this purpose.
- (g) All endowment fund income is to be applied to administration.

- (h) All building fund income is to be accumulated.
2. New subscriptions for 1929 to building fund campaign amount to \$27,000.00.
 3. Pay patients' accounts are considered uncollectible in the amount of \$7,421.00.
 4. Prepaid insurance on December 31, 1929, totals \$1,240.00.
 5. Cost of drugs sold during 1929 amounts to \$11,571.00.
 6. Installment No. 10 on contract for new construction, amounting to \$16,500.00, is approved for payment.
 7. Accrued wages on December 31, 1929, are as follows:

Buildings and Grounds..	\$1,583.00
Household.	1,117.00
Nurses.....	2,710.00

8. Buildings constructed are transferred from the Building Fund accounts upon completion.

Prepare the adjusting entries and the following statements:

As of December 31, 1929:

Balance Sheet (by funds).

For the year ended December 31, 1929:

- General Fund, Principal.
- General Fund, Income.
- Endowment Fund, Principal.
- Endowment Fund, Income.
- Building Fund, Principal.
- Building Fund, Income.

Problem 58-5. The city of Dowell classifies its accounts under four different funds. The balances in the accounts of those funds on January 1, 1932, and on December 31 of the same year, before closing, were as follows:

	January 1	December 31
General Fund:		
Cash.....	\$ 10,162	\$ 21,215
1931 Taxes Receivable.....	15,676	12,429
Accounts Receivable.....	2,325	3,545
Stores.....	9,641	9,533
Permanent Property.....	3,154,695	3,154,695
1932 Taxes Receivable.....		60,838
Estimated Revenue from Taxes.....		225,000
Estimated Revenue from Miscellaneous Sources.. . . .		62,000
Appropriation Expenditures for Current Purposes.. . . .		234,398
Appropriation Expenditures for Capital Additions		8,716
Appropriation Expenditures for Payment of Bonds		25,000
Appropriation Encumbrances (1932).....		5,842
	\$3,192,499	\$3,823,211

	January 1	December 31
Accounts Payable.....	\$ 2,826	\$ 5,626
Reserve for 1931 Taxes.....	10,200	10,200
Reserve for Orders and Contracts.....	3,286	5,842
Reserve for Stores.....	10,000	10,000
Current Surplus.....	11,492	11,603
Bonds Payable.....	250,000	225,000
Capital Surplus.....	2,904,695	2,929,695
1932 Tax Anticipation Notes Payable.....		25,000
Reserve for 1932 Taxes.....		24,766
Revenue from Taxes.....		222,894
Revenue from Miscellaneous Sources.....		64,325
Appropriations.....		276,000
Estimated Budget Surplus.....		11,000
Sale of Old Equipment.....		1,260
	<u>\$3,192,499</u>	<u>\$3,823,211</u>
Water Fund:		
Cash.....	\$ 6,126	\$ 717
Accounts Receivable.....	7,645	5,573
Stores.....	13,826	12,635
Investments of Replacement Fund.....	21,700	24,500
Permanent Property.....	212,604	214,204
Labor and Material Expense..		109,638
Interest on Bonds.....		3,000
Depreciation Charge.....		10,600
Accounts of Prior Years Written Off.....		1,097
Expended for Additions to Plant.....		12,460
	<u>\$ 261,901</u>	<u>\$ 394,424</u>
Accounts Payable.....	\$ 4,324	\$ 4,318
Customers' Deposits.....	1,500	1,600
Replacement Fund Reserve.....	21,700	24,500
Operating Surplus.....	21,773	21,773
Bonds Payable.....	60,000	40,000
Capital Surplus.....	152,604	154,204
Services Billed.....		146,867
Deposits Lapsed.....		60
Interest on Investments.....		1,102
	<u>\$ 261,901</u>	<u>\$ 394,424</u>
Assessment Funds:		
Improvement No. 50:		
Cash.....	\$ 4,653.00	\$ 1,844.00
Assessments Receivable.....	46,829.00	33,414.00
Delinquent Assessments Receivable.....	4,826.00	2,010.00
Public Benefit Receivable.....	5,632.00	4,516.00
Interest on Bonds.....		3,000.00
	<u>\$61,940.00</u>	<u>\$ 44,784.00</u>
Bonds Payable.....	\$60,000.00	\$ 40,000.00
Surplus.....	1,940.00	1,940.00
Interest on Assessments.....	—	2,844.00
	<u>\$61,940.00</u>	<u>\$ 44,784.00</u>

Improvement No. 51:	<u>January 1</u>	<u>December 31</u>
Cash.....		\$ 851.00
Assessments Receivable.....		21,600.00
Public Benefit Receivable.....		2,400.00
		<u>\$ 24,851.00</u>
Bonds Payable.....		\$ 24,000.00
Surplus.....		390.00
Interest on Assessments.....		461.00
		<u>\$ 24,851.00</u>
Trust Funds:		
Cash.....	\$ 3,216.00	\$ 31.00
Investments.....	94,425.00	99,425.00
Premium on Investments.....		800.00
Accrued Interest Purchased.....		260.00
Cemetery Maintenance.....		849.00
Cemetery Expense.....		2,976.00
Policemen's Pensions Paid.....		3,200.00
Firemen's Pensions Paid.....		2,400.00
	<u>\$97,641.00</u>	<u>\$109,941.00</u>
Cemetery Endowment Fund Reserve.....	\$60,000.00	\$ 60,000.00
Policemen's Pension Fund Reserve.....	18,691.00	18,691.00
Firemen's Pension Fund Reserve.....	16,824.00	16,824.00
Cemetery Maintenance Fund Reserve.....	2,126.00	2,126.00
Profit on Sale of Investments.....		600.00
Undistributed Income.....		4,800.00
Policemen's Pension Fund Contributions.....		4,160.00
Firemen's Pension Fund Contributions.....		2,740.00
	<u>\$97,641.00</u>	<u>\$109,941.00</u>

It is the practice of the city to close out the unencumbered balance of appropriations of the general fund at the end of each year. Depreciation on the general property of the city is not entered, and accrued interest on investments and outstanding bonds is disregarded. Income and profit on trust fund investments are distributed as follows: 62%, to cemetery fund; 20%, to policemen's pension fund; and 18%, to firemen's pension fund, in round dollars.

The cemetery maintenance fund consists of the income from the cemetery endowment fund and is used for cemetery expense. Excess of receipts over disbursements of pension funds is closed to the reserve accounts of the respective funds at the end of each year.

Attention is directed to the following facts and conditions at the close of the year 1932:

(1) Taxes for 1931 in excess of the reserve against them are to be written off.

(2) The reserve for 1932 taxes is to be increased 50%.

(3) Invoices on all orders and contracts outstanding at the beginning of the year were paid with a saving of \$111.00, which

amount was credited to Current Surplus.

(4) The old property sold during the year was carried in the accounts at a value of \$6,000.00.

(5) Permanent property valued at \$1,820.00 was discarded during the year.

(6) Replacements of water-department equipment costing \$6,200.00 were made from the replacement fund during the year at a cost of \$7,800.00.

On the basis of the foregoing information prepare:

- (a) A balance sheet of all funds after closing the books on December 31, 1932.
- (b) A statement of the current surplus of the general fund for the year, showing revenues and expenditures.
- (c) A statement of income and expense of the water department for the year.

PROBLEM ON CHAPTER 59

Problem 59-1. From the items following, prepare a detailed statement of the condition of the Day Bank and Trust Company as at the close of business on December 31, 1930.

The balance applicable to the Undivided Profits account must be determined by the candidate.

Acceptances Anticipated	\$ 45,000.00
Acceptances Outstanding	425,000.00
Bank Premises.....	1,250,000.00
Bonds—Other than U. S. Government ..	2,750,000.00
Capital Stock.....	3,000,000.00
Cash on Hand.....	600,000.00
Certificates of Deposit.....	250,000.00
Certified Checks.....	125,000.00
Christmas Clubs	171,000.00
Commercial Deposits.....	6,250,000.00
Coupon Deposits.....	20,000.00
Customers' Liability for Acceptances Executed.....	425,000.00
Demand Collateral Loans.....	2,375,000.00
Discounts.....	4,500,000.00
Dividend Payable—January 1, 1931.....	30,000.00
Due from Federal Reserve Bank ..	1,000,000.00
Due from Sundry Banks	350,000.00
Due to Banks.....	585,000.00
Exchanges for Clearing House.....	200,000.00
Federal Reserve Bank Stock (50% of subscription).....	100,000.00
Furniture and Fixtures.....	100,000.00
Interest Receivable Accrued.....	5,000.00
Letters of Credit—Customers' Liability.....	50,000.00
Letters of Credit Executed for Customers.....	50,000.00
Miscellaneous Real Estate.....	75,000.00
Official Checks.....	46,000.00
Overdrafts.....	4,000.00
Real Estate Loans.....	6,250,000.00
Rediscounts.....	1,500,000.00
Reserve for Contingencies.....	225,000.00
Reserve for Interest, Taxes, and Other Expenses.....	60,000.00
Savings Deposits.....	8,750,000.00
Stock—Other than Federal Reserve Bank Stock.....	175,000.00
Surplus.....	1,500,000.00
Time Collateral Loans.....	3,025,000.00
Undivided Profits (Balance to be determined)	
Unearned Discount.....	40,000.00
United States Government Bonds.....	1,250,000.00
United States Government Bonds Pledged.....	250,000.00
United States Postal Savings Deposits.....	115,000.00

QUESTIONS AND PROBLEMS ON CHAPTER 60

QUESTIONS

Question 60-1. Why do a broker's records contain a double entry system of security entries as well as the double entry system common to other lines of business?

Question 60-2. Illustrate the money and security entries required to record a purchase and subsequent sale of securities.

Question 60-3. Illustrate the money and security entries required to record a short sale and subsequent purchase of securities.

Question 60-4. What is the position book, and what is its purpose?

Question 60-5. What is the significance of the credit money balance and the short security balance in the Failed to Receive account?

PROBLEMS

Problem 60-1. *A*, *B*, and *C* are partners conducting a brokerage business and sharing profits in the proportion of 50%, 30%, and 20%, respectively. As of the close of business on June 30, 1930, they desire to admit *D* to the partnership, *D* to invest in the firm, in cash, sufficient funds to acquire a one-third interest in the partnership net assets after admission, and to share in profits and losses in the future to the extent of $33\frac{1}{3}\%$.

A post-closing trial balance, taken from the books of the firm as of the close of business on June 30, 1930, follows:

	<u>Debit</u>	<u>Credit</u>
Securities owned.....	\$525,000.00	
Customers' accounts, unsecured.....	25,000.00	
Customers' accounts, secured.....	50,000.00	
Accounts with other brokers, secured.....	150,000.00	
Accounts payable.....		\$ 30,000.00
Collateral loans.....		90,000.00
<i>A</i> , Capital.....		300,000.00
<i>B</i> , Capital.....		250,000.00
<i>C</i> , Capital.....		80,000.00
	<u>\$750,000.00</u>	<u>\$750,000.00</u>

For the purpose of determining the partnership net assets, you are to give effect to the following:

Market value of securities owned.....	\$465,000.00
Uncollectible customers' accounts.....	15,000.00
Net depreciated value of furniture and equipment previously expended by the firm.....	21,000.00

Required: Amount invested by *D*; partners' capital accounts.

Problem 60-2. A partner in a stock brokerage firm, not active in the management, suspects his firm of conducting a bucket shop. He secures the following balance sheet from the firm's books, and he asks your advice. He has previously made an examination of customers' accounts and found all accounts, both long and short, amply margined at 20%. The market has been rising steadily for nearly a year. What is your analysis of the situation?

Balance Sheet Items

Cash.....	\$ 400,000.00
Due from customers, long.....	2,500,000.00
Due from brokers for stock borrowed.....	25,000.00
Securities on hand.....	75,000.00
Firm trading accounts, long.....	450,000.00
Due to customers, short.....	375,000.00
Due to brokers for stock on loan.....	150,000.00
Firm trading accounts, short.....	2,850,000.00
Capital, surplus, and profit and loss.....	75,000.00

Problem 60-3. The following is a trial balance taken from the books of Newkirk and McGilvary, stockbrokers, at the close of business on April 5, 1934:

Cash in Banks.....	\$ 800,000.00	
Petty Cash.....	2,000.00	
Accounts Receivable.....	3,690,000.00	
Stocks Borrowed.....	140,000.00	
Stocks Loaned.....		\$ 180,000.00
Failed to Deliver.....	95,000.00	
Failed to Receive.....		147,000.00
Firm Investments.....	2,000,000.00	
Revenue Stamps.....	200.00	
Accounts Payable.....		3,600.00
Accrued Interest.....		4,501.00
Stock Exchange Seat.....	165,000.00	
Furniture and Fixtures.....	1.00	
Expenses.....	136,000.00	
Income.....		157,000.00
Loans Payable.....		2,500,000.00
Frank Newkirk, Capital.....		2,036,100.00
Maurice McGilvary, Capital....		2,000,000.00
	<u>\$7,028,201.00</u>	<u>\$7,028,201.00</u>

During the audit you ascertained the following:

	Ledger Balances	Market Value of Securities
(1) Customers' debit balances—fully secured.....	\$3,760,000	\$4,200,000
(2) " " " —partly secured.....	60,000	50,000
(3) " " " —unsecured.....	36,000	
(4) " free credit balances.....	125,000	
(5) " credit balances—securities short....	200,000	150,000
(6) " short of securities and no money balances.....		15,000
(7) Partners' trading debit balances—securities long	180,000	75,000
(8) Partners' trading credit balances—securities short.....	21,000	45,000
(9) Stocks borrowed.....		150,000
(10) Stocks loaned.....		170,000
(11) Failed to deliver.....		93,000
(12) Failed to receive.....		141,000
(13) Firm investments:		
Long.....		1,800,000
Short.....		150,000
(14) Loans payable to banks, secured by pledge of securities.....		2,850,000
(15) Market value of securities in the box and in transfer.....		2,847,000

Prepare a questionnaire form balance sheet.

Problem 60-4. Having been appointed to ascertain the financial condition of Snow, Frost & Co., stockbrokers, as at June 30, 1934, you and your staff attended the office of this concern at the close of business on the aforesaid date.

The cash and securities on hand (both in the office and in the safe-deposit vault) were counted and listed and details secured regarding securities in transfer, securities deposited as collateral to loans, those held by other brokers for the firm's account, and those held as margin for customers' accounts as well as customers' short commitments. All these data have since been verified by you.

The books of the firm have been closed, under your direction, as at June 30, 1934, the general ledger showing balances as follows:

Cash.....	\$ 75,000.00
Loans payable to banks.....	145,000.00
Due other brokers.....	1,400,000.00
Customers' accounts—Debit.....	1,450,000.00
Customers' accounts—Credit.....	80,000.00
Advances to salesmen.....	750.00
Securities owned.....	400,000.00
Stock exchange seat.....	90,000.00
Partners' capital and undivided profits.....	390,750.00

The securities, mentioned above as verified, have been valued at market as at June 30, 1934, and the following facts relative to such

valuation have been ascertained:

In office and vault	\$ 176,000.00
In transfer.....	15,000.00
Deposited as collateral for bank loans.. ..	190,000.00
Held by other brokers for the firm's account....	1,955,000.00
Owned by firm.....	495,500.00

An analysis of the customers' accounts and a comparison with the value of the securities held as margin therefor, as well as with the value of customers' short commitments, disclosed the following facts:

- (1) The firm held securities having a market value of \$1,787,000.00, as collateral for customers' accounts with ledger debit balances amounting to \$1,337,500.00.
- (2) The firm held securities having a market value of \$90,000.00, as collateral for customers' accounts with ledger debit balances amounting to \$110,000.00.
- (3) Customers' accounts with ledger debit balances amounting to \$2,500.00 were unsecured.
- (4) Customers with ledger credit balances amounting to \$7,500.00, owed the firm, on account of short sales, securities having a market value of \$9,000.00.
- (5) Customers with ledger credit balances amounting to \$42,500.00, owed the firm, on account of short sales, securities having a market value of \$32,500.00.
- (6) Customers' accounts with ledger credit balances amounting to \$30,000.00 had no short commitments.
- (7) Securities having a market value of \$5,000.00, which belonged to customers who had no ledger balances, were included in the securities deposited as collateral for bank loans.

From the foregoing, you are required to prepare a balance sheet, showing ledger balances after proper adjustments based on the security valuations, and reflecting the related security values.

Problem 60-5. The firm of *A, B & C* were dealers in securities for their own account and others. On November 30, 1931, the partnership was dissolved because *C*, whose only capital contribution was his stock exchange seat, desired to withdraw.

A and *B* formed a new partnership, taking over all assets and liabilities of the firm, except the stock exchange seat and the goodwill. (The latter was considered worthless.)

Profits and losses were shared in the ratio of 60, 25, and 15, by *A, B, and C*, respectively.

In addition to the trial balance given herewith, which reflects all routine adjustments and accruals, the following information was gathered, as of November 30, 1931:

Customers' free credit balances.....	\$	202,295.00
Market value of customers' securities short.....		36,752.00
Market value of firm securities short.....		29,649.00
Market value of firm securities long.....		1,008,914.00

Trial Balance—November 30, 1931

Corn Exchange Bank.....	\$	63,215.00	
National City Bank.....			\$ 750,000.00
Failed to Receive.....			185,483.00
Stock Exchange Seat.....	350,000.00		
Goodwill.....	250,000.00		
Profit on Syndicate Transactions.....			215,932.00
Loss on Joint Accounts.....	79,290.00		
Partners' Salaries.....	51,583.00		
Interest Received.....			4,592.00
Dividends Received.....			21,138.00
Stock Clearing Corporation.....	10,000.00		
Failed to Deliver.....	148,660.00		
Accrued Interest.....			2,265.00
Interest Paid.....	68,232.00		
Interest on Partners' Capital... ..	42,880.00		
Salesmen, Office, and General... ..	255,330.00		
Customers' Ledgers.....	660,313.00		228,980.00
Petty Cash.....	852.00		
Brokerage.....	7,543.00		
Commissions.....			80,533.00
Firm Securities Long.....	1,458,664.00		
Firm Securities Short.....			16,429.00
Bank of America.....			270,000.00
Revenue Stamps.....	565.00		
Commissions Receivable.....	4,843.00		
Commissions Payable.....			7,556.00
Accrued Income—Syndicates... ..	5,500.00		
Accrued Expense—Syndicates... ..			201,677.00
Capital Accounts:			
A.....			800,000.00
B.....			350,000.00
C.....			350,000.00
Drawing Accounts:			
A.....	12,192.00		
B.....			16,147.00
C.....	31,070.00		
	<u>\$3,500,732.00</u>	<u>\$3,500,732.00</u>	

From the foregoing data, prepare the opening balance sheet of the new partnership of A & B, as at December 1, 1931.

MISCELLANEOUS PROBLEMS

Problem 1. Selected Securities, Inc., a corporation organized for the purpose of investing in securities, was managed, during the calendar year 1929, by the Specialized Management Corporation, under an agreement which included the following provisions:

“Specialized Management Corporation agrees to manage the financial operations of Selected Securities, Inc., and to provide, in addition to financial counsel, all necessary office facilities and personnel. Expenses, such as interest, taxes, legal and accounting fees, and custody of securities, will be paid by Selected Securities, Inc.

“Selected Securities, Inc. agrees to pay the Specialized Management Corporation for its services as financial adviser, etc., 12% of the net profits realized each year and accrued at the close of each year upon securities held. Such compensation shall not be included as an expense in determining the amount of net profit upon which the compensation is payable.”

From the following trial balance of Selected Securities, Inc., at December 31, 1929, prepare the journal entries required to bring taxes and management compensation accrued upon the books.

SELECTED SECURITIES, INC. Trial Balance—December 31, 1929

Cash at Bank.....	\$ 30,349.02	
Cash on Loan at Call....	100,000.00	
Securities (at cost)*....	1,628,741.20	
Dividends Receivable....	1,250.00	
Cost of Securities Sold..	1,369,520.00	
Legal Fees.....	5,000.00	
Auditing Fees.....	2,600.00	
Interest Paid.....	8,362.00	
Dividends Paid.....	4,000.00	
Securities Sold.....		\$1,507,400.00
Dividends Received.....		28,450.00
Interest Received.....		9,685.32
Rights Sold.....		4,286.90
Capital (40,000 shares, no par value).....		1,600,000.00
	\$3,149,822.22	\$3,149,822.22

* The market value of the securities held at December 31, 1929, was \$1,657,150.00. All rights sold were in respect to securities which had been sold at December 31, 1929.

Prepare also a profit and loss statement for the year ended December 31, 1929, and a balance sheet as at the close thereof.

Determine the liquidating value of the company's stock at December 31, 1929.

The income tax rate for 1929 was 11%; in computing the tax, assume that the dividends, \$28,450.00, were received from domestic corporations and were therefore tax-exempt; that the interest received, \$9,685.32, was not tax-exempt; and that the securities were valued for tax purposes at the lower of cost or market.

Problem 2. From the data following, prepare a profit and loss statement for the year ended December 31, 1933. In addition, show the average gross profit per pound, the selling expense per pound, and the average operating profit per pound.

	Pounds	Amount
Sales.....	2,963,915	\$988,114.00
Raw Material Consumed.....	3,342,730	561,715.00
Inventory—Finished Goods—January 1, 1933 . . .	285,588	80,894.00
Manufacturing Expenses.....		383,508.00
Selling Expenses.....		34,080.00
Waste Recovery.....		18,694.00

The closing inventory of finished goods was shown as 271,753 pounds, valued at the cost of goods manufactured during the year.

Problem 3. On January 1, the inventory at market values of working cattle and live stock on a plantation in the West Indies was as follows:

	Number	Unit Price	Amount
Work animals (bulls and oxen).....	1,588	\$ 52 00	\$ 82,576.00
Horses.....	16	120.00	1,920.00
Cows.....	274	30.00	8,220.00
Heifers.....	137	20.00	2,740.00
Young bulls.....	220	30.00	6,600.00
One-year heifers (under two years)	82	15.00	1,230.00
One-year bulls (under two years).....	127	20.00	2,540.00
Bull calves (under one year).....	137	10.00	1,370.00
Heifer calves (under one year).....	114	10.00	1,140.00
Breeding bulls.....	6	150.00	900.00
Together.....	<u>2,701</u>		<u>\$109,236.00</u>

During the year, 73 heifers were reclassified as cows and 175 young bulls as work animals. All of them were on hand at the end of the year.

The market values remained the same throughout the year except that work animals were worth \$43.00 a head at the end of the year.

During the year, the following changes also took place:

Births:	Purchased (all on hand at the end of the year):
145 bull calves.	120 work animals at \$45.00.
130 heifers.	41 young bulls at \$30.00.
Deaths:	Sold:
261 work animals.	63 work animals.
5 cows.	4 cows.
4 heifers.	2 horses.
3 bull calves.	Lost:
Found:	7 work animals.
8 work animals.	
12 bull calves (new).	
5 heifer calves (new).	

Prepare:

(1) A columnar statement showing opening and closing inventories, and number, unit price, and value, in addition to all numerical changes during the year, making such further adjustments as may be necessary.

(2) A statement showing the amount of the opening inventory, the amounts of increases through appreciation, purchase, birth, and so forth, and of decreases through reduction in market value, sales, and losses, thus arriving at the amount of the closing inventory.

Problem 4. The Marvel Corporation is organized on January 1, 1933, to manufacture men's ready-to-wear clothing. It is planned to use an estimate cost system, incorporated in the general ledger.

(a) The following styles of clothing will be made, and the costs are estimated as follows:

	<u>Style A</u>	<u>Style B</u>	<u>Style C</u>
Materials used.....	\$10.50	\$ 8.00	\$ 4.50
Supplies (linings, buttons, etc.)..	3.50	2.80	2.00
Labor.....	9.00	6.40	4.00
Factory expenses.....	6.75	4.80	3.00
Total.....	<u>\$29.75</u>	<u>\$22.00</u>	<u>\$13.50</u>

Note that the estimated costs are divided into four sections and that the accounts must be kept to record the corresponding subdivisions of operating costs.

(b) The company starts with the following:

Machinery and Equipment.....	\$20,000.00	
Cash.....	30,000.00	
Capital Stock.....		\$50,000.00

(c) The purchases and expenses for the first month according to the voucher record are:

Materials, fine woolens, 2,000 yards @ \$3.20	\$ 6,400.00
Materials, plain woolens, 3,000 yards @ \$1.40 . . .	4,200.00
Rent of factory	500.00
Linings, buttons, thread, etc.	3,100.00
Salesmen's commissions	750.00
Office expenses	320.00
Repairs to machines and equipment	150.00
Electric power	440.00
Oil, waste, and other factory supplies	225.00
	<u>\$16,085.00</u>

(d) The payrolls are summarized as follows:

Foremen	\$ 450.00
Tailors, cutters, etc. (direct labor)	4,900.00
Office and salesmen's salaries	950.00
Inspectors' and other indirect factory wages	735.00
	<u>\$7,035.00</u>

(e) The depreciation on equipment is calculated at 1% per month.

(f) The cutting-room foreman reports that the following materials have been taken from stock and cut for use on garments in process:

- 1,500 yards of fine woolens.
- 2,500 yards of plain woolens.

(g) The tailoring foreman reports that the following garments have been finished and placed in stock:

- Style A—250 pieces.
- Style B—200 pieces.
- Style C—350 pieces.

(h) The sales record is as follows:

Invoice No. 1, Style A—100 pieces	\$ 4,000.00
“ , Style C—150 pieces	3,000.00
No. 2, Style B— 50 pieces	1,500.00
No. 3, Style A—100 pieces	4,000.00
No. 4, Style B— 25 pieces	800.00
“ , Style C—100 pieces	2,100.00
	<u>\$15,400.00</u>

(i) Make an entry for cost of sales.

(j) The amount of cash received from customers was \$7,000.00.

(k) The amount of cash paid out was: for wages, \$7,035.00; for

other vouchers, \$9,040.00.

(1) Inventories at the end of the month (in addition to stocks of raw materials and finished goods as shown by the stock records) are as follows:

Supplies, \$470.00.

Unfinished goods:

Style A—100 pieces:

All material cut.

All supplies provided.

Labor half completed.

Style C—50 pieces:

All material cut.

Half of supplies provided.

Half of labor finished.

(1) Submit a working trial balance covering the above transactions.

(2) Prepare a balance sheet and a profit and loss statement for the month. When preparing the profit and loss statement, add or deduct from cost of sales, the unabsorbed labor, expenses, and so forth.

(3) Show how balances of closing inventories are made up.

Problem 5. Corporation A has contracts with its sales and production managers whereunder each of the latter is to receive, as extra compensation, $2\frac{1}{2}\%$ of the net book profit of the company for the calendar year 1926, after provision for Federal income taxes has been made.

The net book profit for the calendar year 1926, before provision for the extra compensation and for Federal income taxes, was \$95,000.00. There were, however, deductions amounting to \$5,000.00, that had been made in determining the net book profit as stated above, which were unallowable for income tax purposes.

From the foregoing data, compute the amount of Federal income tax payable by the corporation and the amount of extra compensation payable to each of the managers. (The tax rate for 1926 was $13\frac{1}{2}\%$.)

Problem 6. In preparing a balance sheet, to be used in proposed refinancing of a company engaged in the production of wine, which has maintained rather incomplete records, what amount would you use as the value of finished wine on hand, on the basis of the following data?

With respect to the inventory of wine on hand you are able to

determine the following:

- (1) The average cost of grape juice was \$1.55 per gallon, which approximates present market cost.
- (2) The average cost of brandy, of which 5 gallons were used per 50-gallon barrel of finished wine, was \$3.75 per gallon.
- (3) Filtration loss was stated to be, in the aggregate, about 4 gallons to each 50 gallons of grape juice; the Federal Government allowed 6%.
- (4) The total labor cost to produce 40,000 gallons in one year was \$18,000.00.
- (5) The cost of a 50-gallon barrel was \$5.50.
- (6) The plant overhead was about $\frac{1}{3}$ of the labor cost.
- (7) Shrinkage averaged about 1% per annum.
- (8) Carrying charges averaged about 6% per annum.
- (9) Of the 20,000 gallons of wine on hand, 5,000 gallons were 15 years old, and 15,000 gallons were 6 years old.

Submit a work sheet and explain your reasoning.

Problem 7. The following condensed balance sheets reflect the financial condition of the East Company and the King Company on October 15, 1933:

	<u>East Company</u>	<u>King Company</u>
Investment in East Company (20%)		\$ 45,000.00
Investment in King Company (15%)	\$ 45,000.00	
Other Net Assets	130,000.00	195,000.00
Capital Stock and Surplus	<u>\$175,000.00</u>	<u>\$240,000 00</u>

A company with capital stock of \$325,000.00 (the amount of the "Other Net Assets") is organized to combine these two companies. What proportion of the stock should be issued to the outside stockholders of the East Company, who own 80% of the stock of that company, and what proportion should be issued to the outside stockholders of the King Company, who own 85% of the stock of that company?

Problem 8. On June 1, 1933, Louis Small bought a small manufacturing business for a cash consideration of \$30,000.00. He received the following assets free and clear of all liabilities:

Machinery, which had cost \$25,000.00 and which was considered as worth \$20,000.00; lumber, which had cost \$7,000.00, and was worth \$6,000.00 at the market prices then prevailing; and other raw material, which was worth \$1,000.00 at cost and at market.

Small was not to receive any interest in the accounts receivable, but he undertook to collect them for the former owners.

Between June 1 and August 31, 1933, no regular books were kept, and on the latter date Small asks you to open a simple set of books which will record the totals of his transactions to date. He also asks you to prepare a balance sheet. He is able to supply the following information from memoranda he has kept:

Cash collections:	
On old accounts receivable.....	\$3,500.00
On new accounts receivable.....	8,000.00
Cash disbursements:	
Wages.....	\$2,500.00
Other factory expenses.....	300.00
Paid former owners on account.....	2,000.00
Collection expenses on old accounts.....	100.00
Material purchases.....	5,000.00
Open items at August 31, 1933:	
Old accounts receivable uncollected.....	\$2,250.00
New accounts receivable uncollected.....	5,710.00
Factory expenses unpaid.....	225.00
Material bills unpaid.....	1,900.00
Cash on hand—August 31, 1933.....	1,410.00
Material on hand—August 31, 1933: at market price, \$5,800.00; at cost.....	\$6,500.00

Prepare the journal entries necessary to record the transactions to date, and a balance sheet on August 31, 1933.

Problem 9. The books of Bokar Corporation, a concern engaged in the manufacture of foundry castings, show, after inventory, December 31, 1934, materials and finished work on hand as follows:

Pig iron, \$8,500.00; heavy scrap iron, \$350.00; foundry scrap, \$105.00; coke, \$840.00; limestone, \$90.00; other materials, \$690.00; and finished castings, \$3,065.00.

Inventory—January 1, 1934, as follows: pig iron, \$12,600.00; heavy scrap iron, \$600.00; foundry scrap, \$150.00; coke, \$254.50; limestone, \$65.00; other materials, \$3,140.00; and finished castings, \$1,875.00.

Purchases during the year, as follows: pig iron, \$115,600.00; heavy scrap iron, \$7,400.00; foundry scrap, \$825.60; coke, \$12,000.00; limestone, \$375.00; and other materials, \$7,725.00. Cash discount on purchases, \$2,340.60; freight, \$810.80.

The sales were \$230,000.00; cartage outward, \$1,965.10; discount on sales, 1%; taxes, \$325.00; insurance, \$175.00; labor, \$60,250.00; foundry foreman, \$3,100.00; office salaries, \$2,500.00; salesmen's salaries and expenses, \$15,250.00; and office expenses, \$8,010.00.

Depreciation on plant, \$4,000.00.

Prepare a statement showing production cost and year's profit from operations.

Problem 10. The books of The Devoe Company had been audited as of December 31, 1934, as of which date the auditors found adjustments necessary for the following:

Repairs charged in error to the Machinery and Equipment account.	\$ 3,500.00
Required provisions for depreciation for the year 1934:	
Buildings.....	2,100.00
Machinery and Equipment.....	12,000.00
December pay roll entered on books in January, 1935:	
Factory Labor.....	5,200.00
Administrative and Office Salaries.....	2,000.00
Salesmen's Salaries.....	500.00
Overstatement of inventory.	8,050.00

A merger with Thorne Company, under the new name of The *D-T* Company, was effective as of June 30, 1935, and in connection therewith the auditors were again called in to prepare a balance sheet as of that date, together with an operating statement for the six months then ended. The auditors found that the adjustments recommended as of December 31, 1934, had not been entered on the books. The trial balance taken from the books as of June 30, 1935, was as follows:

Cash.....	\$ 14,500.00	
Accounts Receivable.....	66,000.00	
Inventory.....	165,500.00	
Unexpired Insurance.....	2,000.00	
Land.....	10,000.00	
Buildings.....	85,000.00	
Machinery and Equipment.....	150,000.00	
Notes Payable.....		\$ 100,000.00
Accounts Payable.....		28,000.00
Reserve for Doubtful Accounts.....		5,000.00
Capital Stock.....		250,000.00
Surplus.....		91,500.00
Sales.....		531,000.00
Discount Earned.....		3,500.00
Factory Labor.....	195,000.00	
Purchases.....	202,000.00	
Factory Supplies and Expense.....	1,000.00	
Insurance.....	2,500.00	
Maintenance—Building and Equipment.....	27,000.00	
Taxes.....	7,000.00	
Administrative and Office Salaries.....	35,000.00	
Advertising.....	7,500.00	
Miscellaneous and General Expense.....	9,000.00	
Salesmen's Salaries.....	12,800.00	
Traveling Expense.....	8,200.00	
Discount Allowed.....	8,000.00	
Interest Expense.....	1,000.00	
	<u>\$1,009,000.00</u>	<u>\$1,009,000.00</u>

No attempt had been made by the bookkeeper to adjust the prepaid and accrued accounts as of June 30, 1935; the correct amounts follow:

Accrued Taxes.....	\$2,100.00
Unexpired Insurance..	2,800.00

The property additions for the six months were found to have been properly capitalized. Depreciation is to be allowed on the annual basis of 3% on buildings and 10% on machinery and equipment, figured on the June 30, 1935, balances. The inventory, as checked by the auditors, aggregated \$185,000.00.

In connection with the merger with Thorne Company, it was planned to sell preferred stock in an amount sufficient to liquidate the notes payable and provide \$150,000.00 additional working capital, the balance of the stock to be 50,000 shares of common stock without par value. It was agreed to allot the common stock to the two participating companies at the rate of four no-par shares for each \$100.00 of net worth, with the balance of the shares (valued at \$10.00 each) to be allotted as payment for goodwill, on the basis of the excess of the net earnings for the one and one half years ended June 30, 1935, over 10% on the net assets as of June 30, 1935.

The audited earnings of the two companies for the period involved had been as follows:

	<u>Thorne Company</u>	<u>Devoe Company</u>
1934.	\$41,685.00	\$10,635.00
Six Months Ended June 30, 1935.....	20,000.00	

The balance sheet of Thorne Company, accepted for allotment of stock under the merger, was as follows:

Cash.....	\$ 20,500.00
Accounts Receivable.....	85,250.00
Inventories.....	58,240.00
Plant and Equipment.....	150,500.00
Deferred Charges.....	6,015.00
	<u>\$320,505.00</u>
Accounts Payable.....	\$ 25,965.00
Reserve for Depreciation.....	35,840.00
Capital Stock.....	50,000.00
Surplus.....	208,700.00
	<u>\$320,505.00</u>

Prepare:

- (1) A balance sheet of the Devoe Company as of June 30, 1935, after necessary adjustments have been made.
- (2) An operating statement of the Devoe Company for the six

months ended June 30, 1935.

(3) A schedule showing the number of shares of common stock of The *D-T* Company to be allotted to the two companies, under the merger plan as outlined.

(4) Working papers showing the opening balance sheet of The *D-T* Company.

Problem 11. Prepare a balance sheet as at December 31, 1933, and a profit and loss account for the year ended that date.

COMPANY A, INC.

Trial Balance—December 31, 1933

	Debit	Credit
Cash.....	\$ 260,000	
Accounts Receivable—Customers.....	520,000	
Furniture and Fixtures.....	20,000	
Depreciation Reserve—Furniture and Fixtures.....		\$ 2,000
Auto Trucks.....	60,000	
Depreciation Reserve—Auto Trucks.....		20,000
Accounts Payable—Trade.....		45,000
Accrued Pay Roll and Property Taxes.....		10,000
Capital Stock (authorized and issued, 55,000 shares)		777,000
Sales.....		720,000
Purchases—Lumber, Steel, etc.....	430,000	
Wages.....	225,000	
Depreciation—Auto Trucks.....	20,000	
Depreciation—Furniture and Fixtures.....	2,000	
Lease Rentals.....	25,000	
Selling and Administrative Expenses.....	12,000	
	<u>\$1,574,000</u>	<u>\$1,574,000</u>

Company A, Inc. rented display equipment on contract, and had obtained contracts for \$720,000.00, covering a period of three years from January 1, 1933. The contracts provided that the company would bill for the earned portion of the contract price at the rate of \$20,000.00 at the end of each month, beginning January 31, 1933.

The display equipment available for rental was constructed entirely by Company A, and during the month of January, 1933, such equipment was produced at a cost of \$600,000.00, with an estimated average productive life of five years.

The locations on which the display equipment was erected had been leased to Company A for a period of five years from January 1, 1933, and the leases specified that rents for the full period were payable in advance on January 1, 1933.

All display equipment owned by Company A was in use under the contracts noted. Maintenance of this equipment in efficient operating condition cost the company \$55,000.00 annually.

Problem 12. The X Company sells a loose-leaf service for \$115.00 and contracts to issue to customers, semiannually on April 1 and October 1, renewal and replacement pages for \$15.00 per annum.

The initial purchase price covers the original publication and one year's renewal pages, and customers are billed in advance for each subsequent year's renewal pages on the anniversary dates of the original sales.

The company's books at December 31, 1931, showed the following transactions:

Sales of original publication (uniformly 200 sets a month),	
2,400 sets @ \$115.00	\$276,000.00
Sales charges for renewal pages, 4,500 sets @ \$15.00.....	67,500.00

Sales of original publication for preceding years were:

	Number of Sets Per Month
1927.....	50
1928.....	75
1929.....	100
1930.....	150

The production cost of the original publication was \$30.00 per set, and that of renewal pages, \$2.50 per semiannual issue.

In closing its records for the year 1931, the company credited the foregoing sales of both categories to profit and loss, in accordance with the uniform practice followed since the initiation of this particular department.

As auditor, would this procedure meet with your approval? State what modifications you would suggest, showing the actual gross profits from both sources for the year 1931, and the adjustments applying to other periods.

Problem 13. In the production of a main product and its one by-product, a manufacturer utilizes six production departments. Raw material, when placed in process, passes first through the reduction department, in which it is fused into a clinker mass. It then passes to the grinding department and next to the mixing department. From the mixing department it passes to the extraction department, at which point the by-product emerges. Both products next pass to the finishing department and to the packing department.

Raw material is composed of two elements, as follows:

- Y: 55% costs \$ 70.00 per ton.
- X: 45% costs 110.00 per ton.

In the mixing department, chemicals (equal in total weight to the materials previously used) are added, as follows:

- A: 25% costs \$ 40.00 per ton.
 B: 60% costs 80.00 per ton.
 C: 15% costs 160.00 per ton.

Material storage and handling cost is computed at 8% of material cost.

Direct labor cost is computed on tonnage handled in each department.

Direct department expense and indirect department expense are computed as a percentage of direct labor cost.

The following are the direct labor costs and expense percentages:

<u>Department</u>	<u>Direct Labor Per Ton of Main and By-products</u>	<u>Direct Department Expense</u>	<u>Indirect Department Expense</u>
Reducing.....	\$20.00	40%	30%
Grinding.....	22 00	150	30
Mixing.....	30.00	250	30
Extraction.....	24.00	200	30
Finishing.....	60.00	60	30
Packing.....	36.00	40	30

In the extraction process, 80% of material placed in process becomes main product. Of the remaining portion, which is sent to the finishing department along with the main product, two thirds emerges as completed by-product. There is no loss in finishing the main product.

It takes approximately twice as long to finish a ton of the by-product as it does to finish a ton of the main product.

The by-product is sold at a net profit of \$96.00 per ton, after consideration has been given to its share of factory costs. No commercial expenses are assigned to the by-product.

The main product is sold for \$900.00 per ton. It is charged with commercial expenses at the rate of 15% of sales price.

Determine the cost per ton of the by-product and the profit per ton of the main product sales.

Problem 14. From the information following, prepare:

(1) The journal entries, as required, on the books of the three companies, recording the purchase of the investments at April 1, June 30, and September 1, 1929.

(2) A statement showing the amount of goodwill and capital surplus arising from consolidation, as at December 31, 1929.

In making an audit of the books of account and records of the Smith Theatre Company and its subsidiaries—the Brown Pictures, Incorporated, and the Green Amusement Company—for the year ended December 31, 1929, you find the following conditions:

The Brown Pictures, Incorporated (hereafter alluded to as “the corporation”), was organized on January 1, 1929. The incorporators, owners of theatres in favorable locations, leased their theatres, with equipments, to the corporation for a period of twenty years beginning January 1, 1929, and received, in consideration therefor, all the capital stock of the corporation, in addition to an annual fixed rental payable by the lessee in advance in equal monthly installments on the first day of each month.

The capital stock of the Brown Pictures, Incorporated, consists of 10,000 shares of no par value and was issued, according to the articles of incorporation, for leaseholds appertaining to the leased theatres, appraised by the incorporators at date of organization at \$120,000.00. With reference to the issue of the stock, you find the following journal entry on the books of the corporation:

Leaseholds.....	120,000.00	
To Capital Stock.....		120,000.00

You also find that, during the year 1929, the corporation has amortized the leaseholds by charges to the Profit and Loss account on the basis of the lives of the leases.

On April 1, 1929, the Smith Theatre Company purchased from individual stockholders of the Brown Pictures, Incorporated, 5,000 shares of the capital stock of that corporation for \$70,000.00 in cash, and on September 1, 1929, acquired from the remaining stockholders the balance of the stock, which was paid for in the following manner:

- (a) One hundred shares of the Smith Theatre Company’s no-par value common stock held in the treasury, purchased at \$35.00 a share, the market value being \$45.00.
- (b) A sum in cash equal to the increase in the rental under an amendment of the lease of the Star Theatre, one of the theatres originally leased to the Brown Pictures, Incorporated, which had been rented by the Brown Pictures, Incorporated, at date of organization from the stockholders now desirous of selling their stock. The original Star Theatre lease agreement provided for a rental of \$60,000.00 per annum and stipulated that the corporation deposit with the lessors the sum of \$60,000.00, bearing interest at 6% per annum, which was to be applied as rental for the last year of the term. The deposit

was made by the corporation on January 1, 1929. The amended lease agreement contained the following provisions:

Term—October 1, 1929, to December 1, 1948.

Rental—\$72,000.00 per annum from Oct. 1, 1929, to Sept. 30, 1939.

\$70,000.00 per annum from Oct. 1, 1939, to Dec. 1, 1947 (payable as in the case of the first lease).

\$60,000.00 for the balance of the term, covered by the lease deposit originally made by the lessor.

The original lease was canceled and settlement for the lease deposit was made in cash.

- (c) Cancellation of the interest accrued on the lease deposit from January 1, 1929, to September 1, 1929, the amount thereof to be credited to the Brown Pictures, Incorporated.

The Green Amusement Company was organized on January 1, 1929, with an authorized capital stock of 1,000 shares of no par value issued for cash, in amount of \$35,000.00. This company was indebted to the Smith Theatre Company on a note with a face value of \$15,000.00. Owing to the unsatisfactory financial condition of the Green Amusement Company, the Smith Theatre Company accepted the note only after indorsement thereof by 95% of the stockholders of the Green Amusement Company.

With the consent of the Smith Theatre Company, the indorsers of the note, anxious to free themselves of their contingent liability, which was likely to become actual, entered into an agreement on June 30, 1929, with the Brown Pictures, Incorporated, whereby they sold to that corporation all their capital stock of the Green Amusement Company, upon condition that the Smith Theatre Company cancel the note and that the Brown Pictures, Incorporated, assume the liability therefor on open account.

The books of the respective companies were closed quarterly. An analysis of the surplus accounts at December 31, 1929, was as follows:

	Smith Theatre Co.	Brown Pictures, Inc.	Green Amuse- ment Co.
Balance—Jan. 1, 1929 (as certified by you)..	\$ 840,000		
Profits or losses*:-			
3 months ended Mar. 31, 1929.....	150,000	\$120,000	\$ 5,000*
3 months ended June 30, 1929.....	140,000	130,000	9,000*
3 months ended Sept. 30, 1929.....	175,000	135,000	12,000*
3 months ended Dec. 31, 1929.....	178,000	140,000	15,000*
Balances—December 31, 1929.....	<u>\$1,483,000</u>	<u>\$525,000</u>	<u>\$41,000*</u>

The capital stock of the Smith Theatre Company consists of 10,000 shares of no-par value common stock, issued at \$15.00 a share.

Wherever it becomes necessary, in your calculations, to assume an interest rate, use 6% per annum.

The profits or losses for the three months ended September 30, 1929, may be assumed to have occurred in equal amounts by months.

Given: The present worth of an annuity payable \$1.00 monthly for ten years, the first payment to be made in one month, is \$90.075. The present worth of an annuity payable \$1.00 monthly for eight years and two months, but with the first payment of the annuity beginning in ten years, or directly after the former annuity ceases, is \$42.500083.

Problem 15. Following is the trial balance of the recently organized Glenview Golf Club as at December 31, 1933:

	<u>Debit</u>	<u>Credit</u>
Cash in Bank.....	\$ 7,225.00	
Accounts Receivable, Members.....	11,160.00	
Buildings.....	54,500.00	
Equipment.....	8,500.00	
Golf Course Construction.....	130,000.00	
Labor.....	26,285.00	
Golf Course Supplies and Expense.....	12,446.00	
General Expense.....	4,213.00	
Interest Paid.....	5,617.00	
Rent.....	6,000.00	
Commissions—Soliciting Membership.....	1,100.00	
Notes Payable—Bank.....		\$ 10,000.00
Accounts Payable.....		2,341.00
Entrance Fees.....		146,250.00
Dues.....		22,950.00
Green Fees.....		5,015.00
Taxes on Dues and Entrance Fees.....		490.00
Entrance Fees Underwritten.....		80,000.00
	<u>\$267,046.00</u>	<u>\$267,046.00</u>

A proprietary membership in the club costs \$1,000.00 plus a \$100.00 tax.

An analysis of the Entrance Fees account shows that it includes \$110,000.00 paid in—which amount represents the payment in full of 110 memberships—and \$36,250.00 collected from sixty members. The balance due from these sixty members, plus the tax thereon, is secured by notes for their original unpaid balance. These notes are on hand but not entered.

In September, 1933, a special committee, appointed for the

purpose, handed in a statement with a list of eighty members, each of whom promised to obtain a new member and to advance the entrance fee of such member at once, subject to repayment when the new member paid in his fee; accordingly, the following entry was then made:

Accounts Receivable, Members.....	80,000.00	
To Entrance Fees Underwritten.....		80,000.00

Of the above \$80,000.00, \$70,000.00 had been collected from the underwriters at December 31, 1933. Nothing had been repaid to the underwriters on account of new members, although ten such new members had been elected in December and had paid in \$8,800.00 in cash and signed notes for \$2,200.00 for entrance fees and taxes.

Dues are \$200.00 a year, plus a 10% tax, payable quarterly in advance, and have been chargeable and entered on April 1, July 1, and October 1, 1933.

Included in "Accounts Receivable, Members" are accounts totaling \$330.00, for dues and taxes against two members who have been delinquent for nine months, and accounts aggregating \$770.00, for dues and taxes of eight other members. Collections can be enforced only by deduction from the proceeds of sale of such memberships after the complement of 300 members has been attained.

The Buildings account includes:

Caddy and locker house.....	\$10,000.00
Architect's plans for a club house, discarded because the proposal appeared too expensive.....	3,000.00
Architect's fees for new club house.....	1,500.00
Payments under a cost-plus contract for the club house (under construction December 31, 1933), with a guaranteed maximum cost of \$50,000.00...	40,000.00
	<u>\$54,500.00</u>

The golf course was finished and opened on June 30, 1933. At that date, the club being obliged to maintain the course, since the original construction contract was completed, the operating accounts stood as follows:

Debits:	
Labor.....	\$10,116.00
Golf course supplies and expense.....	4,539.00
General expense.....	916.00
Interest paid.....	2,890.00
Rent.....	6,000.00
Credits:	
Dues.....	5,950.00

The club leases its real estate, for which it pays an annual rental of \$6,000.00, payable January 1 in advance.

The estimated life of the equipment is five years from June 30, 1933.

Of the liability on the books for taxes on dues, \$390.00 is now payable to the collector of internal revenue, representing collections in December.

Prepare the journal entries which should be made on the books as of December 31, 1933, and January 1, 1934, disregarding closing entries, since the fiscal year ends on June 30.

Submit also a statement of assets and liabilities as of the opening of business on January 1, 1934.

Problem 16. You are engaged by a firm of attorneys to advise and aid in a general reorganization of their offices, with particular reference to accounting procedure, cost, and so forth.

Upon investigation you find that it has been the practice to keep a chronological record of hours spent upon each undertaking and, upon completion of a matter, to bill the client from this record, taking into consideration preëstablished minimum rates per hour for the various partners and attorneys, the nature of the work, and so forth.

The operations of the firm as a whole result in a profit, but no attempt beyond rough estimates has ever been made to determine the cost per hour to the firm of each member of the staff. Further investigation leads you to believe that much individual work is done at less than cost.

You discuss the situation with the firm members, and you are requested to prepare for their consideration a comparative table showing the direct, overhead, and total costs per hour to the firm of each partner and attorney, in comparison with the minimum billing rates in effect.

Construct the required table from the above information and the following data:

- (a) The three partners are actively engaged in the practice of law.
- (b) The legal staff, including the partners, numbers nine, and may be designated by numbers in your solution, numbers 1 to 3 being the partners.
- (c) The normal working year per man is conceded to be 1,981 hours, and 181 hours per annum are considered a reasonable allowance per man for all non-chargeable time.
- (d) The partners draw \$1,000.00 each per month, which sum they consider as salary. The annual salaries of the

members of the legal staff are:

Number 4—\$5,400.00.	Number 7—\$3,600.00.
“ 5— 4,800.00.	“ 8— 3,600.00.
“ 6— 4,200.00.	“ 9— 2,400.00.

- (e) The minimum billing rates per hour are: Numbers 1, 2, and 3, \$10.00; Number 4, \$7.50; Number 5, \$6.50; Number 6, \$4.50; and Numbers 7, 8, and 9, \$3.00.
- (f) The firm's actual expenses for the year under review (exclusive of partners' drawings) were as follows:

Salaries:	
Legal Staff.....	\$24,000.00
Stenographers.....	15,641.00
Others.....	8,155.00
Rent.....	18,301.00
Stationery and Supplies.....	3,730.51
Telephone and Telegraph.....	3,101.15
Depreciation.....	2,514.63
Miscellaneous Expenses.....	3,066.98
	<u>\$78,510.27</u>

Problem 17. The Pine Lumber Company is the owner of a tract of timber, of which it is estimated there will be 1,330,000,000 feet remaining to be cut at January 1, 1931. The company intends to cut off this timber and manufacture it over the ensuing ten years, and its present plant, main-line railroad, and equipment, allowing for normal replacements, may be assumed to be adequate for that purpose.

In the analysis of the accounts for the three years ended June 30, 1930, the following items of expenditure were shown:

New plant extension.....	\$385,750.00
Plant and main-line railroad replacements.....	101,070.00
Equipment replacements.....	116,480.00
Construction of logging spurs.....	217,300.00
Total.....	<u>\$820,600.00</u>

Plant and main-line railroad replacements as given above may be considered normal for a three-year period under the usual operating conditions. Equipment replacements may likewise be assumed to be normal, but it is to be expected that necessary purchases of new equipment will depend upon the number of feet cut.

It is estimated that the construction of logging-railroad spurs into 1,000,000,000 feet of the remaining timber will cost \$900,000.00; spurs already constructed are available for logging 330,000,00 feet.

The company's operations for the three years from June 30, 1927, to June 30, 1930, during which it manufactured 364,000,000 feet of lumber, are summarized as follows:

Net sales of lumber and inventory adjustments.	\$8,736,000.00
Cost of sales:	
Logging, manufacturing labor and expense.	\$6,576,770.00
Amortization of logging-railroad spurs	172,900.00
Depreciation—plant and main-line railroad.	213,500.00
Depreciation—equipment.	133,910.00
Depletion of timber.	728,000.00
	<u>7,825,080.00</u>
Gross profit.	\$ 910,920.00
Selling and administrative expenses, taxes, etc.	976,230.00
Operating loss.	\$ 65,310.00
Interest paid.	158,850.00
Net loss for the three-year period.	<u>\$ 224,160.00</u>

In order to liquidate all of its present indebtedness, the company is about to negotiate a loan for \$1,000,000.00, to be dated January 1, 1931, with interest at 6% per annum on the unpaid balance, the principal payable in ten equal annual instalments beginning December 31, 1931.

Using as a basis, sales prices and expenditures as experienced for the three years to June 30, 1930:

Prepare a statement of the "conversion value" of the timber remaining at January 1, 1931—that is, the cash funds to be realized from the operations of the company, available for liquidation of the principal under the proposed loan or for other purposes. Calculate the "conversion value" or cash funds to be realized per thousand feet of timber to be cut, making your computations to the nearest tenth of a cent.

Prepare also a statement comparing payments to be met in each year under the proposed loan with the cash funds to be available each year, assuming that all the timber will be cut and manufactured in equal annual amounts.

Note: The foregoing relates to the determination of "conversion value," now commonly required by long-term creditors of timber operators, and requires statements other than the orthodox balance sheet and profit and loss statement.

Problem 18. From the following trial balance and explanatory data, prepare:

- A balance sheet as of December 31, 1930.
- A statement of operating cost for the year ended December 31, 1930.
- A statement of profit and loss for the year ended December 31, 1930.

MISCELLANEOUS PROBLEMS

SAMOSSET LOGGING COMPANY—CAMP NO. 1

Trial Balance—December 31, 1930

	<u>Debit</u>	<u>Credit</u>
Cash in Bank.....	\$422,500.00	
Petty Cash.....	1,750.00	
Accounts Receivable.....	165,450.00	
Inventories:		
Cook house.....	250.00	
Wangan*.....	150.00	
Standing Timber (Stumpage).....	157,800.00	
Clearing Cost.....	2,400.00	
Machinery and Equipment (Rigging).....	22,400.00	
Tools (Felling and Bucking).....	1,250.00	
Cable (Rigging).....	8,200.00	
Skidroads (Rigging).....	29,000.00	
Office Fixtures.....	1,500.00	
Notes Payable.....		\$ 50,000.00
Accounts Payable.....		18,750.00
Payrolls Accrued.....		37,100.00
Bonds—6%.....		100,000.00
Capital Stock.....		500,000.00
Labor.....	59,400.00	
Rigging Maintenance.....	4,850.00	
Sundry Operating Expenses.....	900.00	
Cook house Purchases.....	12,350.00	
Cook house Sales.....		15,250.00
Wangan Purchases.....	1,210.00	
Wangan Sales.....		1,320.00
Log Sales.....		185,200.00
Salaries—Administrative.....	10,000.00	
Office Expenses.....	2,550.00	
Sundry Expenses—General.....	710.00	
Bond Interest.....	3,000.00	
	<u>\$907,620.00</u>	<u>\$907,620.00</u>

* *Wangan*: A flatboat used by Maine lumbermen for transporting their tools and provisions.

You obtain the following additional information:

- (1) There was no inventory of logs on hand at January 1, 1930, either in wood or in water.
- (2) The estimate of the tract contents was 60,000,000 feet.
- (3) During the year, 26,040,000 feet were logged, and 25,470,000 feet were rigged (placed in heaps or piles).
- (4) Inventories at December 31, 1930, were:

	<u>Dollars</u>	<u>Feet</u>
Cook house.....	\$300.00	
Wangan.....	160.00	
Logs in heaps or piles.....		2,320,000
Logs felled and bucked.....		570,000

- (5) Logs sold—23,150,000 feet.
 (6) The Labor account was analyzed as follows:

Felling and bucking.....	\$17,100.00
Rigging.....	36,550.00
Cook house.....	3,540.00
Wangan.....	2,210.00
Total.....	<u>\$59,400.00</u>

- (7) Bond interest is payable semiannually, July 1 and January 1, and the dividend declared is 3%.

Depreciation of furniture and fixtures is to be provided on the basis of footage sold. Depreciation of other fixed assets is to be provided in proportion to footage handled.

Divide the net costs of operating the cook house and the wangan, and the sundry operating expenses into two equal amounts, charging half to felling and bucking and half to rigging.

EXPLANATORY NOTES

A logging company buys timberland (standing timber), cuts it down, saws it into logs, and sells the logs.

The timber is first "cruised" by an expert, who reports upon the approximate amount and condition of each kind of timber on each section.

The land may be sold for a lump sum, at so much per acre or so much per thousand feet logged.

When the land is close to a river, the skidroad process is employed; if it is too far away from a river, railroads are built. Frequently, the combination process is used.

When a section "goes under the axe," a camp is built, a road cleared; and skidroad or railroad, or both, constructed. The cost is spread over the section cleared, since such equipment is worthless when this particular part is exhausted.

The processes employed are felling, bucking (sawing into logs), branding (a different mark being used for each section), logging, and hauling—over skidroad, by railroad to a landing on a river bank, or direct to the mill. If the logs are dumped into a river, a boom, owned generally by an outsider, is necessary for sorting.

The logs, rafted or railroaded to the mill, are then graded and measured by both owner and buyer. As soon as the content of either raft or car is determined, the mill sends the owner (logger) a credit memorandum for it.

Problem 19. Following are the condensed balance sheets of Companies A, B, C, and D, as at the close of business, December 31, 1930:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>
Assets				
Cash.....	\$ 10,000	\$ 20,000	\$ 4,500	\$ 20,000
Accounts Receivable.....	90,000	180,000	145,000	280,000
Accounts Receivable from <i>B</i>	40,000			
Accounts Receivable from <i>C</i>		50,000		
Accounts Receivable from <i>D</i>			75,000	
Inventories:				
Raw Materials.....	75,000	100,000	90,000	100,000
Finished Goods.....	60,000	70,000	80,000	90,000
Investments:				
Capital Stock of <i>A</i>				50,000
Capital Stock of <i>B</i>	50,000			50,000
Capital Stock of <i>C</i>		100,000		50,000
Capital Stock of <i>D</i>	10,000			
Plant and Property.....	1,580,000	1,970,000	2,175,000	3,110,000
	<u>\$1,915,000</u>	<u>\$2,490,000</u>	<u>\$2,569,500</u>	<u>\$3,750,000</u>
Liabilities				
Notes Payable.....	\$ 90,000	\$ 100,000	\$ 160,000	\$ 220,000
Accounts Payable to <i>A</i>		40,000		
Accounts Payable to <i>B</i>			50,000	
Accounts Payable to <i>C</i>				75,000
Capital Stock.....	1,000,000	1,400,000	2,000,000	3,000,000
Surplus.....	825,000	950,000	359,500	455,000
	<u>\$1,915,000</u>	<u>\$2,490,000</u>	<u>\$2,569,500</u>	<u>\$3,750,000</u>

The capital stock of the several companies owned by the other companies was purchased at par and is in each instance carried on the books at cost.

A consolidation is proposed and decided upon, and the *N* Banking Company is engaged to make the necessary arrangements for this purpose. The banking company succeeds in securing agreements from the stockholders of the four companies, *A*, *B*, *C*, and *D*, all complying with the terms of the proposal whereby a new company is to be organized and known as the *X Y* Company.

During the past five years, dividends have been paid annually as follows: *A*, 16.55%; *B*, 17%; *C*, 15%; and *D*, 12½%. It is agreed to allow goodwill to the companies equal to the amount of dividends paid by each company during the past five years. It is further agreed that the return of all merchandise sold to, and bought by, one or other of the companies, be accepted and that the full price paid therefor be allowed. The average percentage of net profit on intercompany sales has been: *A*, 20%; *B*, 30%; *C*, 25%; and *D*, 35%.

All of the raw materials of *D* were bought from *C*; those of *C* were bought from *B*; and those of *B* were bought from *A*. *A* purchased its raw materials in the open market.

The inventories of all companies have been carried on the books at cost.

The *X Y* Company's authorized capital stock is to consist of 2,000,000 shares of no par value. The stockholders of *A*, *B*, *C*, and *D* have agreed to accept 1,500,000 shares, in return for their own stock and holdings of the other companies, which are to be issued at the nominal value of \$10.00 each, in payment of their individual interests in the respective companies. Five hundred thousand shares are to be held for sale by the *N* Banking Company, at not less than \$10.00 a share.

The estimated amount of reorganization and financing expenses is \$2,000,000.00, which sum is to be paid from the proceeds of the sale of the stock held by the banking company. The balance of the proceeds of the sale of the stock is to be turned over to the *X Y* Company as additional working capital.

From the foregoing, after effect has been given to the transactions enumerated, prepare:

(1) A balance sheet of the *X Y* Company, to submit to the clientele of the *N* Banking Company for investment purposes.

(2) A statement of the amount of shares of capital stock that will be received by the holders of stock of *A*, *B*, *C*, and *D*, respectively.

Problem 20. A fire insurance company is formed on January 1, 1933, with a capital stock of \$500,000.00 and paid-in surplus of \$250,000.00. It expects to conduct a business that will result in a premium income (after deducting reinsurance and return premiums) for the first two years of \$360,000.00 and \$450,000.00, respectively, and of not less than \$630,000.00 for each succeeding year.

It is desired to keep the commission cost within 25% and the other operating expenses at \$100,000.00 each year.

For the purpose of the reserve for unearned premiums, it may be assumed: (a) that June 30 is the average date of expiration of all premiums; and (b) that the premium income is equally divided between one-year, three-year, and five-year policies. For the purpose of interest, you may assume that the company received from its investments, \$40,000.00 the first year, \$50,000.00 the second year, and \$60,000.00 each year thereafter.

You are required to make an estimate of income and expense, in tabular form, for the first five years ending December 31, assuming the fire loss ratio to premium income earned to be 50%. Show how much higher a ratio than 50% the company could bear each year without impairing its capital.

Problem 21. *A*, *B*, *C*, and *D* form a syndicate for the purchase of coal mines owned by *A*, for the purpose of selling them to a

new corporation, The Northern Coal Company.

This corporation is formed with a stock capital of \$2,250,000.00, composed of 20,000 7% preferred shares of \$100.00 each, and 2,500 shares of common stock of \$100.00 each.

The subscribers pay cash in full for 3,500 preferred shares, *B* paying for 1,500 shares, *C* for 1,000 shares, and *D* for 1,000 shares. The remaining 16,500 preferred shares and also the 2,500 shares of common stock are to be transferred by the company to *A* as the purchase price of the properties.

The agreement made by the members of the syndicate among themselves is that *A* is to keep 3,000 preferred shares as the actual price of the properties; that he is to transfer, as gifts to *B*, *C* and *D*, one preferred share for each share paid for by them; and that he is to donate to the corporation 10,000 preferred shares, which are to be sold and the proceeds credited to Surplus account. He is, further, to donate to the syndicate the 2,500 shares of common stock which he received.

A market is to be made for this common stock, and when it is sold, the net proceeds are to be divided, as promotion profits, among all the members of the syndicate in proportion to their final holdings of preferred stock.

The common stock realized an average net price of \$90.00 per share. The preferred shares, donated to the company, realized an average net price of \$102.00 per share.

Prepare the accounts of the syndicate, showing the distribution of profit on the sale of the common stock; and prepare the balance sheet of the corporation after the sale of the donated stock.

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