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Students' Department

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Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

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

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 12, 1931, 1:30 P. M. to 6:30 P. M.

The candidate must answer the first three questions and one other question:

No. 1 (30 points):

The trial balance (condensed) of Company A, as at December 31, 1930, was as follows:

	DR.	CR.
Cash	$ 2,438	
Accounts receivable	37,097	
Inventories—January 1, 1930:		
Raw material	7,492	
Jobbing goods	2,564	
Finished goods	10,473	
Machinery and equipment	14,622	
Prepaid insurance	1,300	
Purchases:		
Raw material	88,838	
Jobbing goods	44,045	
Sales:		
Manufactured goods—net		$163,721
Jobbing goods		54,601
Sundry accounts, apart from those detailed, applicable to cost of manufacturing and cost of sales	43,232	
Sundry expense accounts, applicable to profit and loss	51,312	
Notes and accounts payable		24,215
Reserves:		
For depreciation		12,021
For doubtful accounts		3,500
To reduce "Company B's" account to inventory cost value—January 1, 1930		144
Capital stock		18,500
Surplus		26,711
	$303,413	$303,413

Included in the accounts receivable of Company A is an account with "Company B," which is in reality a title only, used by A in selling merchandise on consignment to certain small dealers.

An analysis of this account, as it appears in the accounts-receivable ledger of Company A, is as follows:

	Dr.	Cr.
Balance—January 1, 1930	$ 3,600	
Shipments during 1930	632	
Selling expenses	58	
Cash collections during 1930		$ 2,344
Credit memos. issued in 1930 for goods returned		2,560
	$ 4,290	$ 4,904
		4,290
		$ 614

All cash collected from the customers of "B" is credited to this company's account on the books of A. This procedure has been in vogue for several years.

A list of balances of customers' consignment accounts of "B" totals $1,218 (which is accepted as correct), representing the prices at which the garments are sold to the public by the customers of "B." These customers remit only for garments actually sold and deduct 20 per cent. for their profit. A garment billed to "B" by Company A at the latter's regular selling price of $2 is then sold to the public by the customers of "B" for $2.90. The same proportion holds throughout. Shipments, inventories and sales consist of 75 per cent. of manufactured goods and 25 per cent. of jobbing goods.

On the articles handled by "B," Company A earns a gross profit of 35 per cent. on its selling price on manufactured goods and 25 per cent. on jobbing goods.

A physical inventory of goods on hand at the plant of Company A, at the close of business, December 31, 1930, was as follows:

Raw material	$6,780
Jobbing goods	4,463
Finished goods	7,246

From the foregoing trial balance and following data, prepare

(1) Journal entries necessary to adjust the account of "Company B;"
(2) Statement of cost of goods manufactured and cost of sales;
(3) Statement of profit and loss for the year ended December 31, 1930;
(4) Balance-sheet as at the close of business, December 31, 1930.

Solution:

(1) Journal entries necessary to adjust the account of Company B.

(1)

Reserve to reduce Company B's account to inventory cost value—January 1, 1930	$ 144.00	
Accounts receivable—(B)		$ 144.00

To transfer the reserve account to accounts receivable (B).

(2)

Inventory—manufactured goods—January 1, 1930	2,592.00	
Inventory—jobbing goods—January 1, 1930	864.00	
Accounts receivable—(B)		3,456.00

To set up the inventories of finished goods at January 1, 1930, charged to accounts receivable (B) as follows:

Balance—January 1, 1930	$3,600.00
Less—reserve	144.00
Adjusted balance	$3,456.00

Manufactured goods (75%)	$2,592.00		
Jobbing goods (25%)	864.00		
Total	$3,456.00		

(3)

Sales—manufactured goods		$474.00	
Sales—jobbing goods		$158.00	
Accounts receivable (B)			632.00
To charge the sales accounts with the shipments to Company B as follows:			
Manufactured goods (75%)	$ 474.00		
Jobbing goods (25%)	158.00		
Total	$ 632.00		

(4)

Selling expenses		58.00	
Accounts receivable (B)			58.00
To transfer the charge for selling expenses from the accounts receivable (B).			

(5)

Accounts receivable (B)		2,344.00	
Sales—manufactured goods			1,758.00
Sales—jobbing goods			586.00
To transfer to the sales accounts the sales of Company B.			
Manufactured goods (75%)	$1,758.00		
Jobbing goods (25%)	586.00		
Total	$2,344.00		

(6)

Accounts receivable (B)		2,560.00	
Sales—manufactured goods			1,920.00
Sales—jobbing goods			640.00
To reverse the entry to accounts receivable (B) of credit memoranda issued in 1930 for goods returned.			
Manufactured goods (75%)	$1,920.00		
Jobbing goods (25%)	640.00		
Total	$2,560.00		

Computation of inventory on consignment at December 31, 1930.

The goods billed to Company B include a gross profit on sales of 35 per cent. on the manufactured goods, and 25 per cent. on the jobbing goods.

Company B in turn bills these goods to consignees on the basis of $2.90 for every $2 of cost to it, or at a billed price of 145 per cent. of cost. The consignment customers' accounts represent inventories at cost, plus the two profits noted above.

Consignment customers' accounts at prices billed to customers by Company B		$1,218.00
Cost to Company B is, therefore, $1,218 ÷ 145%, or...		$ 840.00
which is made up of:		
Manufactured goods (75%)	$ 630.00	
Jobbing goods (25%)	210.00	840.00
As the cost to Company B includes a profit for manufactured goods of 35% and for jobbing goods of 25%, the		
Cost to Company A is:		
Manufactured goods, as above	$ 630.00	
Less—gross profit of 35%	220.50	
		$ 409.50
Jobbing goods, as above	$ 210.00	
Less—gross profit of 25%	52.50	
		157.50
Total inventory at cost to Company A of goods out on consignment at December 31, 1930		$ 567.00

(2) Company A

Statement of cost of goods manufactured and sold for the year ended December 31, 1930

Particulars	Manufactured goods	Jobbing goods	Total
Inventory—raw materials, January 1, 1930	$ 7,492.00	$	$ 7,492.00
Inventory—jobbing goods, January 1, 1930		3,428.00	3,428.00
Total	$ 7,492.00	$ 3,428.00	$ 10,920.00
Purchases during the year, 1930	88,838.00	44,045.00	132,883.00
Finished goods inventory, January 1, 1930	13,065.00		13,065.00
Sundry accounts, applicable to cost of manufacturing and cost of sales	43,232.00		43,232.00
Total	$152,627.00	$47,473.00	$200,100.00
Deduct—inventories at December 31, 1930:			
Raw materials	$ 6,780.00	$	$ 6,780.00
Finished and jobbing goods	7,655.50	4,620.50	12,276.00
Total deduction	$ 14,435.50	$ 4,620.50	$ 19,056.00
Cost of goods manufactured and sold	$138,191.50	$42,852.50	$181,044.00

(3) Company A

Statement of profit and loss for the year ended December 31, 1930

Particulars	Manufactured goods	Jobbing goods	Total
Sales	$166,925.00	$55,669.00	$222,594.00
Cost of sales (2)	138,191.50	42,852.50	181,044.00
Gross profit on sales	$ 28,733.50	$12,816.50	$ 41,550.00
Sundry expenses applicable to profit and loss			51,370.00
Net loss for the year ended December 31, 1930			$ 9,820.00

(4) Company A

Balance-sheet—December 31, 1930

Assets

Current assets:				
Cash			$ 2,438.00	
Accounts receivable		$37,711.00		
Less—reserve for bad debts		3,500.00		
			34,211.00	
Inventories:				
On hand:				
Raw material	$6,780.00			
Jobbing goods	4,463.00			
Finished goods	7,246.00			
		$18,489.00		
On consignment:				
Finished goods	$ 409.50			
Jobbing goods	157.50			
		567.00		
			19,056.00	
				$55,705.00
Machinery and equipment			$14,622.00	
Less—reserve for depreciation			12,021.00	
				2,601.00
Prepaid insurance				1,300.00
				$ 59,606.00

Liabilities and net worth

Current liabilities:			
Notes and accounts payable			$ 24,215.00
Net worth:			
Capital stock		$18,500.00	
Surplus:			
Balance January 1, 1930	$ 26,711.00		
Less—loss for year (3)	9,820.00		
		16,891.00	
			35,391.00
			$ 59,606.00

No. 2 (25 points):

Companies M and P are engaged in the exploitation, development and production of minerals. They decide to consolidate and form a Company K with a capital stock of 100,000 shares of no par value.

Under certain rights, acquired for nominal considerations, the holdings of Companies M and P have proved to be very valuable, principally because of discoveries of extensive underground deposits, the cost of which was considerably less than the present intrinsic values.

A disinterested appraisal has been made, and, based upon this appraisal and other assets apart from those appraised, the capital stock of K is to be issued to the stockholders of the subsidiary companies in the following proportions: for each share of M, two shares of K and for each share of P, four shares of K.

The appraisal shows the value of the properties of M to be $2,600,000 and those of P, $4,400,000.

All the stock is exchanged, with the exception of 100 shares of M. Later, 20,000 shares of K stock are sold for cash at $100 a share.

The accounts of M and P, as at the date of consolidation, were as follows:

	M	P
Cash	$ 200,000	$ 100,000
Property	1,600,000	1,800,000
Sundry other assets	500,000	100,000
	$2,300,000	$2,000,000
Sundry liabilities	$ 300,000	$ 600,000
Reserves for depletion and depreciation	800,000	600,000
Capital stock	1,500,000	1,000,000
Surplus (deficit)	300,000	200,000
	$2,300,000	$2,000,000

From the foregoing information

(a) Prepare journal entries to record transactions on books of K.
(b) Prepare a consolidated balance-sheet (in detail) explaining eliminations and adjustments.
(c) Explain basis on which minority interests are computed.
(d) How do you show capital accounts on the consolidated balance-sheet and why?
(e) How do you show property accounts on the consolidated balance-sheet and why?
(f) In preparing a consolidated balance-sheet and income statement as of a subsequent date, what adjustment, if any, would you make with regard to reserves for depletion of mineral deposits?

Solution:

Before the journal entries to record the transactions on the books of Company K can be prepared, it is necessary to consider whether or not the appraised values should be expressed upon the books, and what value should be assigned to the no-par-value stock of Company K. The problem leaves both of these points to the judgment of the candidate. Using the wholly owned subsidiary, Company P, as an example, and assuming a composite rate of 10 per cent. for depreciation and depletion, and that the stock of the subsidiary is $100 par value, let us consider the possible methods of solving the problem.

1. As 20,000 shares of capital stock of Company K were sold for cash at $100 a share, that valuation may be assigned to the 40,000 shares of no-par-value stock of Company K exchanged for the 10,000 shares of stock of Company P. If the appraised values of the property are not expressed upon the books of Company P, we find that the value of the stock of Company K ($4,000,000) is $3,200,000 in excess of the book value of the stock of Company P ($800,000) received in the exchange. Under ordinary circumstances, this excess would be called goodwill. However, as it is shown that the value of the property carried on the books of Company P is understated by $3,200,000 (appraised value, $4,400,000 minus book value, $1,200,000), an adjustment should be made in the consolidated working papers to restate the property valuation and to increase the net worth or book value of the stock of Company P.

But what adjustments for depreciation and depletion, if any, are to be made at a subsequent date? Assume that Company P has a profit at the end of the year of $500,000 before deducting depreciation and depletion of $120,000. The profit of $380,000 would increase the net assets of Company P to $1,180,000. The parent company, K, would take up the profit of $380,000 by a charge to investment account and a credit to surplus. However, in eliminating the investment account against the net worth of Company P, we find:

Investment account on books of Company K......	$4,000,000	
Add—profits for the year........................	380,000	
Total at end of the year........................		$4,380,000
Book value of stock of Company P at the beginning of the year..................................	$ 800,000	
Add—profits for the year........................	380,000	1,180,000
Difference.................................		$3,200,000

The excess of the investment account over the book value of the stock of the subsidiary company, considered as an increase in property valuation, rather than as goodwill, has not changed during the year. Obviously, this treatment can not be correct, for if the property account has been increased in the consolidated statement by $3,200,000, some provision for depreciation and depletion should be made on the appreciated values.

2. Let us assume as another choice, that the appraised values were taken up on the books of Company P, by charges of $2,600,000 to the property account, $600,000 to the reserves for depletion and depreciation, and a credit of $3,200,000 to appraisal surplus account. The new book value of the stock of Company

P would be $4,000,000 which would be equal to the balance in the investment account of Company K.

But what adjustments are to be made at the end of the year to account for the depreciation and depletion? Most textbooks would recommend that the realized appreciation be accounted for on the books of Company P as follows:

Profit and loss	$440,000	
Reserves for depreciation and depletion		$440,000
To set up depreciation and depletion on the appraised value of the property at the rate of 10% per annum.		
Profit and loss	60,000	
Surplus		60,000
To transfer the remaining balance in the profit-and-loss account into surplus.		
Appraisal surplus	320,000	
Surplus		320,000
To credit surplus account with the realized appreciation.		

Or as an alternative,

Profit and loss	120,000	
Reserves for depreciation and depletion		120,000
To set up depreciation and depletion at the rate of 10% per annum on the cost (?) of property.		
Profit and loss	380,000	
Surplus		380,000
To transfer the remaining balance in profit-and-loss account into surplus.		
Appraisal surplus	320,000	
Reserves for depreciation and depletion		320,000
To set aside the depreciation and depletion on the excess of appraised values over book value.		

Under this method, the net assets of Company P at the end of the year would be:

Assets:			
Cash and sundry assets		$200,000	
Increase in assets (profit)		500,000	
Property—appraised	$4,400,000		
Less—reserves	440,000	3,960,000	
Total assets			$4,660,000
Liabilities			600,000
Net assets			$4,060,000

But what amount should be taken up by the holding company as profit and as an increase in its investment account? The consolidated profit-and-loss statement should show, in the case of Company P, a profit for the year of

$380,000. If this amount is taken up by Company K, its investment account would show a balance of $4,380,000 which is $320,000 (the amount of the realized appreciation) in excess of the book value of the subsidiary. In preparing the consolidated balance-sheet, the elimination of the investment account against the book value of the subsidiary would leave, each year, a balance increased by the amount of each year's realized appreciation. And this increasing balance certainly can not be considered as goodwill. On the other hand, if the holding company takes up a profit of $60,000 ($500,000 minus $440,000), how will the profit of the operating company ($380,000) be reconciled with the consolidated profit of both companies ($60,000)?

If Company P had sold its assets to Company K for $4,000,000 instead of exchanging its stock, the profits of Company K would appear as $60,000, as the depreciation and depletion of $440,000 would be based upon cost to Company K.

3. As a further choice, let us consider a valuation of the no-par capital stock of Company K based upon the book values without giving any effect to the appraised values whatsoever. The 40,000 shares of stock of Company K would be placed on its books at $800,000, the book value of Company P, or at the rate of $20 a share. It is questionable whether such a valuation was intended, for it seems that a balance-sheet showing a value of $20 a share would not aid in the selling of any unissued stock at a price of $100 a share for cash. Furthermore, there are many who would favor the stating of appraised values on the books, in the circumstances outlined in this problem, as the correct showing of the financial condition of the business.

The profit of Company P, based upon depreciation and depletion of $120,000, would appear in the consolidated profit-and-loss statement at $380,000, and that amount would be taken up by the holding company. No difficulty would be encountered in the preparation of the consolidated balance-sheet, as the book value of Company P of $1,180,000 would be in agreement with the investment account of Company K.

4. In this solution, an attempt is made to avoid the disadvantages noted above, by recording an appraisal surplus on the books of the holding company. The journal entries and working papers are self-explanatory. (c) The minority interest in Company M, represented by the 100 shares of the stock of that company which were not exchanged, is shown in the consolidated balance-sheet in detail. The capital stock is valued at the assumed par value of $100 a share, and the proportionate interest represented by that stock in the deficit and appraisal surplus is set forth. The requirements of sections (d) and (e) regarding the capital and property accounts are discussed above. (f) Under the method used in the solution, the profits of the subsidiaries should be taken up by Company K, by a charge to the investment accounts and a credit to surplus. The depreciation and depletion on the appreciation should be accounted for by a charge to appraisal surplus and a credit to the reserves for depreciation and depletion.

(A) Journal Entries to Record Transactions on the Books of K

Investment in Stock of Company M	$1,800,000	
Investment in Stock of Company P	3,200,000	
Appraisal surplus		$5,000,000

		Dr.	Cr.
To record on the books of Company K the excess of appraised values over book values of property of Companies M and P.			
Investment in stock of Company M		$1,192,000	
Capital stock—outstanding			$1,192,000
To record the issuance of 29,800 shares of no-par-value capital stock of Company K in exchange for 14,900 shares of capital stock of Company M.			
Net worth of Company M:			
Capital stock	$1,500,000		
Deficit	*300,000*		
Net worth	$1,200,000		
Shares outstanding	15,000		
Book value a share	80		
Investment in stock of Company P		800,000	
Capital stock—outstanding			800,000
To record the issuance of 40,000 shares of no-par-value capital stock of Company K in exchange for 10,000 shares of capital stock of Company P.			
Net worth of Company P:			
Capital stock	$1,000,000		
Deficit	*200,000*		
Net worth	$ 800,000		
Cash		2,000,000	
Capital stock—outstanding			2,000,000
To record the issuance of 20,000 shares of no-par-value capital stock of Company K for cash at $100 a share.			

(B) COMPANY K AND ITS SUBSIDIARIES, COMPANIES M AND P

Consolidated Balance-sheet

Date

Assets

Cash	$2,300,000
Property (as appraised)	7,000,000
Sundry other assets	600,000
Total assets	$9,900,000

COMPANY K AND ITS SUBSIDIARIES, COMPANIES M AND P

Consolidated balance-sheet—working papers

Date

Assets	Companies K	M	P	Adjustments and eliminations Debit	Credit	Consolidated Balance-Sheet	
Cash	$2,000,000	$ 200,000	$ 100,000			$2,300,000	
Property:							
Company M		1,600,000		$1,800,000 (3)	$ 800,000 (1)	(2,600,000)	
Company P			1,800,000	3,200,000 (4)	600,000 (2)	(4,400,000)	
Sundry other assets		500,000	100,000			600,000	
Investment in stock of Company M—cost	2,992,000				1,800,000 (3)		
Eliminate:							
Capital stock					1,490,000 (A)		
Deficit				*298,000* (A)			
Investment in stock of company P—cost	4,000,000				3,200,000 (4)		
Eliminate:							
Capital stock					1,000,000 (B)		
Deficit				*200,000* (B)			
Total	$8,992,000	$2,300,000	$2,000,000				
Liabilities and net worth							
Sundry liabilities		$ 300,000	$ 600,000				$ 900,000
Reserves for depletion and depreciation:							
Company M		800,000		800,000 (1)			
Company P			600,000	600,000 (2)			
Capital stock:							
Company K—89,800 shares outstanding	$3,992,000						3,992,000
Company M		1,500,000					
Eliminate holding company's interest				1,490,000 (A)			
Minority interest							10,000 (M)
Company P			1,000,000	1,000,000 (B)			
Deficit:							
Company M		*300,000*					
Eliminate holding company's interest					298,000 (A)		
Minority interest							*2,000* (M)
Company P			*200,000*		200,000 (B)		
Appraisal surplus:							
Company M	5,000,000						
Holding company's interest							1,788,000
Minority interest							12,000 (M)
Company P							3,200,000
Total	$8,992,000	$2,300,000	$2,000,000	$9,388,000	$9,388,000	$9,900,000	$9,900,000

Liabilities and Net Worth

Sundry liabilities			$ 900,000
Minority interest in Company M:			
Capital stock	$10,000		
Appraisal surplus	12,000	$ 22,000	
Deduct—Deficit		*2,000*	
			20,000
Net worth:			
Capital stock—no par value—authorized 100,000 shares—issued and outstanding—89,800 shares		$3,992,000	
Appraisal surplus		4,988,000	8,980,000
Total liabilities and net worth			$9,900,000

Explanations of adjustments and eliminations in working papers.

Numbers one (1) and two (2) record the transfer of the excess of the appraised values over book values of the property of the subsidiaries from the investment accounts to the property accounts.

Numbers three (3) and four (4) write off the reserves for depreciation and depletion carried upon the books of the subsidiaries.

(A) and (B) record the eliminations of the investments in Company M (A) and Company P (B), and the holding company's interest in the book values of those companies.