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Correspondence: Consolidated Balance-Sheets

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Correspondence

Theory and Practice

Editor, The Journal of Accountancy:

SIR:—I do not expect that the more experienced accountants will be benefited much by perusing this article but I do hope that students and beginners will learn something that will add to their knowledge.

CONSOLIDATED BALANCE-SHEETS

The theory of consolidated balance-sheets is well established and needs no further discussion. Mistakes easily can be made in their preparation and constant care should be exerted to avoid them. In solutions of the following problem, given in the Illinois, 1913, examination, I think, Professor A. E. Andersen, Mr. H. A. Finney, Mr. David Himmelblau and Mr. Seymour Walton show the combined goodwill at $1,530,000. The date of the write-up of the S. B. investment by the L. W. Co. determines whether the combined goodwill is $1,530,000 or $1,630,000. Professor Andersen says that he assumed that the write-up occurred after Jan. 1, 1912. Mr. Finney says that the time does not matter. Mr. Walton ignores the time and makes a grave mistake in the application of the $100,000 dividend from the L. W. Co. on the books of the parent company.

PROBLEM

From the following three trial balances prepare a consolidated balance-sheet as at December 31, 1912, in the form you would draw it up for presentation to the stockholders of the parent company (the Safety Razor Company) showing as separate items therein (a) the total goodwill of the combined companies; and (b) the net profits accruing to the new corporation, viz., to the Safety Razor Company.

Safety Razor Company

Trial Balance at December 31, 1912

Preferred stock		$1,500,000.00
Common stock		1,500,000.00
Investments in subsidiary companies—4,000 shares of stock of L. W. Co. and 4,000 shares of stock of Steel Blade Co., both of $100.00 each at cost	2,500,000.00	
Accounts payable		20,000.00
Dividends from subsidiary companies		100,000.00
Administration expenses	25,000.00	
L. W. Co. current account	100,000.00	
Steel Blade Company advances	150,000.00	
Cash	270,000.00	
Organization expenses	75,000.00	
	$3,120,000.00	$3,120,000.00

L. W. Company

Trial Balance at December 31, 1912

Properties and plant	325,000.00	
Goodwill	250,000.00	
Investment in Steel Blade Co.—2,000 shares of a par value of $100 each cost $300,000.00	400,000.00	
Inventories	250,000.00	
Receivables	195,000.00	
Cash	90,000.00	
Capital stock (4,000 shares)		400,000.00
Accounts payable		125,000.00
Steel Blade Company		175,000.00
Surplus (includes $100,000.00 added to book value of investment in Steel Blade Co.)		710,000.00
Safety Razor Co.		100,000.00
	$1,510,000.00	$1,510,000.00

Steel Blade Company

Trial Balance at December 31, 1912

Goodwill	$50,000.00	
Property and plant	325,000.00	
Inventories	190,000.00	
Receivables, general	105,000.00	
L. W. Company	195,000.00	
Cash	10,000.00	
Capital stock (6,000 shares)		$600,000.00
Accounts payable		90,000.00
Safety Razor Company		150,000.00
Surplus or deficit		35,000.00
	$875,000.00	$875,000.00

In the preparation of your consolidated balance-sheet be guided by the following assumed facts:

1. That the Safety Razor Co. was formed on March 28, 1912, and acquired its stock ownership in the two subsidiary companies, as shown in its trial balance on April 1, 1912.

2. That at January 1, 1912, the L. W. Company had a surplus of $605,000.00 and the Steel Blade Company a deficit of $50,000.00.

3. That no inventory was taken of either the L. W. Company of the Steel Blade between January 1 and December 31, 1912, the business of the companies being continued without interruption notwithstanding the change in ownership of the capital stock as indicated above.

4. That prior to December 31, 1912, the L. W. Company declared a dividend of $100,000.00 payable to the parent company which was duly taken up on the books of both companies, being passed through the current accounts and charged against the surplus of the L. W. Company prior to December 31, 1912.

5. That the differences in the current accounts between the Steel Blade Company and the L. W. Company represents as to $10,000.00 merchandise in transit, and as to the remaining $10,000.00 a charge for rental of warehouse for the last six months of 1912, which has been credited to the rent account on the books of the Steel Blade Company.

6. That it is estimated on reliable authority which may be accepted as final that from January 1, to March 31, 1912, the net profits of the L. W. Company amounted to $30,000.00 while during the same period the Steel Blade Company lost $15,000.00.

Attach your consolidating working papers to the consolidated balance-sheet you prepare.

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As the problem does not say when the write-up occurred we have to use our imagination. It does say that at Jan. 1, 1912, the L. W. surplus was $605,000 and that the net profits to March 31, 1912, were $30,000. Isn't it against reason that L. W. wrote up the investment between January 1 and March 31, 1912, in the face of S. B. Company's loss of $15,000 during that period? Certainly L. W. could have gained nothing, because only $30,000 profits were recognized. It appears to me that the only logical assumption is that the write-up occurred prior to Jan. 1, 1912, and is included in L. W. Company's Jan. 1, 1912, surplus of $605,000. Any solution of this problem should state the assumed time of the write-up. Assuming that it occurred prior to Jan. 1, 1912, the parent company acquired as at March 31, 1912.

	L. W. Co.	S. B. Co.
Capital stock	$400,000	$600,000
Surplus	635,000	
Deficit		65,000
Total	$1,035,000	$535,000

The nature of the assets would be shown by this tabulation.

	L. W.	S. B.	Inter-company elimination	Combined
Goodwill	$250,000	50,000		$300,000
S. B. investment	400,000		400,000	
Other assets	385,000	485,000		870,000
Total	$1,035,000	$535,000	$400,000	$1,170,000

The parent company paid $2,500,000, so it acquired additional goodwill of $1,330,000, making the total goodwill $1,630,000.

Mr. Walton shows a goodwill of $1,530,000, so he is estopped from claiming that he assumed that the write-up occurred prior to Jan. 1, 1912. And then he makes a grave mistake. On the books of the Safety Razor Company (the parent company) he credits the $100,000 dividend from the

L. W. Company to surplus. He accepted the Jan. 1, 1912, surplus of $605,000 as real; so he had to assume that the write-up occurred after Jan. 1, 1912. A simple tabulation will show that upon this basis between April 1 and Dec. 31, 1912, L. W. Company made profits of only $65,000.

L. W. Co.	
Surplus, Dec. 31, 1912,	$710,000
Deduct write-up	100,000
Adjusted surplus	$610,000
Deduct rental	10,000
	$600,000
Add dividend paid	100,000
	$700,000
Deduct surplus at March 31, 1912	635,000
Net profits April 1 to Dec. 31, 1912,	$65,000

Therefore on the books of the parent company only $65,000 of the dividend would be credited to surplus; $35,000 would be credited to the $2,500,000 investment account. To credit the whole $100,000 as profits and to claim goodwill of only $1,530,000 is a contradiction.

Unrealized Profits

It is well known that unrealized profits should not be carried into profit and loss account, but in practice do accountants always perceive the unrealized profit? The following problem offers an excellent illustration of unrealized profits that were considered as earned. Undoubtedly the problem was originated for the sole purpose of testing the candidate's knowledge of adventure accounts and I hazard the guess that the originator had no idea that it raises the question of unrealized profits.

Problem

Two merchants, C. F. Munton and W. A. Spencer, agree to share equally in a joint adventure in trade to the West Indies.

On March 1, 1907, they charter a small vessel and purchase and ship materials which cost them $197.00, for which Munton gives his cheque.

This cargo they consign to John Smith, their agent at Havana, which he disposes of, and in return ships on board the same vessel 4,000 cases of commodity A and 100 cases of commodity B; and he draws on Munton at sight for $125.00, this being the amount of the agent's charges and disbursements over and above the net proceeds of the cargo consigned to him. Munton accepts and pays the bill. On April 1st, the vessel arrives, whereupon Munton pays sundry charges of $337.50. Spencer pays the freight, amounting to $493.00. On April 4th Munton sells 1,000 cases of commodity A to Henry Chamberlain for $239.58, and collects $150.00, and on April 10th Spencer collects the rest.

About this time Mr. Spencer happens to have occasion for 1,400 cases of commodity A, which he takes on April 14th, and with Munton's consent values at $291.66. He also takes 10 cases of commodity B, valued at $47.50. Munton sells the other 1,600 cases of commodity A on April 20th to John Walters for $383.33, and a month after accepts $382.50 in full payment.

Mr. Munton next sells on April 25th the other 90 cases of commodity B in barter for 30 cases of commodity C, which he and Spencer divide equally between them.

The goods being thus disposed of, Munton presents his bill of charges, which comes to $22.66, and desires to have accounts stated between Mr. Spencer and him.

You are required to give the ledger accounts of the joint adventure, recording the foregoing transactions as follows:

Joint adventure account,
C. F. Munton
W. A. Spencer
Henry Chamberlain
John Walters

and also W. A. Spencer's account in C. F. Munton's ledger, showing his joint adventure with W. A. Spencer.

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As we are considering only the profits it is sufficient to show only the

JOINT ADVENTURE ACCOUNT.

(W. A. Spencer and C. F. Munton)

Material	$197.00	Chamberlain	$239.58
Draft	125.00	Spencer	339.16
Sundries	337.50	Walters	383.33
Freight	493.00	Spencer	213.75
Discount	.83	Munton	213.75
Munton's charges	22.66		
Spencer, ½ profit	106.79		
Munton, ½ profit	106.79		
	$1,389.57		$1,389.57

No particular knowledge is required to arrive at the above result and any good bookkeeper ought to be able to solve the problem down to this point. The accountant should perceive the actual facts and point out that while Spencer took 1400 cases of commodity A at about three cents per case less than Chamberlain and Walters paid for it, it is hardly probable that he got it at cost. Spencer also took 10 cases of commodity B, valued at $47.50. Then the 30 cases of commodity C apparently were valued at $427.50, but we do not know if this is the original cost or the market value, and we do not know if to Spencer and Munton commodity C is raw material or finished product.

Spencer should have taken the goods at or near market value, and very likely he did; but if he did not Munton does not make a profit on the goods he takes, and Spencer does not make a profit on the goods Munton takes, and Munton sacrifices profits on all goods taken by Spencer in excess of his own takings of similar goods.

If the goods were taken at market value, Spencer is crediting profits on goods taken by himself, and Munton is crediting profits on goods he took, and the goods taken by each are valued at the market price on the books of each, and the anticipated profits on those goods are included in the $106.79 credited by each as their net profits.

If to Spencer and Munton the goods are raw materials the supposed profits would be considered as profits only for adventure statistics, and should be treated as a reduction of the cost of the material.

The question of unrealized profits is the most important part of the problem and a solution without a discussion of it ought not to be considered correct.

Cemetery and Land Accounts

No doubt it is well known that the property set aside by cemetery and land companies for parks, streets, garden houses, stations, etc., should be charged to general property account, but I do not know of anyone saying what eventually is to be done with it. When about all of the lots have been sold it will be found that the general property cannot be realized. To provide for this eventuality the general property should be recognized as a wasting asset and as each lot is sold general property reserve credited with an equitable portion.

Contractors' Accounts

It is well settled that the only safe method is to carry all contracts at cost until completed and accepted and that no profit should be taken in the meantime. However, if at the closing period the contractors insist upon crediting the pro rata profits and all reasonable contingencies have been provided for, I don't see how the accountant can refuse to assent but he must clearly state them as pro rata profits.

If a withdrawing partner demands his share of the pro rata profits and it is decided to pay him, then, while the pro rata profits are figured on the cost up to that time, it is well to point out that if material on hand is not considered, the settlement probably will be inequitable. If material was purchased shortly before the partner withdrew, and is not paid for and is unused, it would certainly seem unjust to the remaining partners for the withdrawing partner to receive profits on its cost. On the other hand if the material had been purchased a long time and had been paid for it would seem unjust to the withdrawing partner not to allow him profits on its cost. The accountant should perceive all the possibilities and explain them to the partners and request instructions.

If in addition to work by the contractor's own force, a sub-contract has been let and payments thereupon made on a percentage basis I think the accounts are best presented on the balance-sheet in this manner:

(Credit)

Blank contract		$100,000
Actual cost to date	$62,000	
Contingent liability upon sub-contract	8,000	70,000
		$30,000
Sub-contractor Smith—		
Percentage retained	2,000	
Contingent liability	8,000	10,000
		$40,000

If pro rata profits are paid to a withdrawing partner the amount should appear as a deduction from the contract, not because the liability thereupon is diminished but because the expected profits being included in the contract price that amount had been distributed.

Club Initiation Fees

Authorities tell us that membership fees and initiation fees are a source of profit to a club, but are not usually considered operating profits. Mr. Seymour Walton goes so far as to say that if a club is sufficiently prosperous to afford it they should not be credited to profits at all but should be considered capital receipts which should be used to pay for the club property or to redeem bonds. He apparently says that the financial condition determines the accounting treatment, but of course he does not mean that. Undoubtedly he will agree that the purpose of the fee determines the treatment. If for the purpose of obtaining money with which to purchase club property, or to retire indebtedness, or to create a reserve, or for other particular purposes, the fees are not operating profits in any sense but are donated surplus. I see no reason at all why the fees do not become operating profits after the particular purpose has been achieved. If property were purchased the repairs, renewals and depreciation would be operating charges and the fees should be treated as operating income to offset those charges.

If in the administration of the affairs of a club and the conservation of its finances, the governors do not anticipate all reasonable expenses and provide for income enough to defray them we can well let the financial condition influence us in determining the purpose of the fees. If the condition is strong we can argue that the dues and other income were expected to provide for all operating expenses and that the fees were for some particular purpose. If it is weak we can argue that it was planned that the fees were to be considered operating income. But it is easily possible for the financial condition to indicate one treatment and the known purpose demand the other. If the governors did plan for such income and included the fees in the estimate the fees are operating income. If they did not include the fees the fees are surplus donated for some particular purpose.

Mr. Walton incorrectly uses the term "capital receipts." Mr. H. C. Bentley correctly defines capital receipts as being money or other evidences of value which are caused by the creation of or addition to fixed liabilities, or the reduction of or realization on fixed assets. Initiation fees are not capital receipts—they are either profits or donated surplus.

Yours truly,

JOSEPH ROBINSON.

V. Marvin Womack and James R. Harper announce the formation of a partnership under the title of Womack & Harper, 1516 Hurt building, Atlanta, Georgia.

It is announced that the firm of Whittlesey, Myer & Wythes has been discontinued. Willis S. Whittlesey and H. A. Wythes continue practice under the firm name of Whittlesey & Wythes at 30 Church Street, New York, and George W. Myer will continue practice at 60 Wall Street, New York.

Edward Clifton Smith announces the removal of his office to the Johnston building, 30 Broad Street, New York.

Rankin & McAlpine announce the removal of their offices to suite 805, American Exchange National Bank building, Dallas, Texas.

Arthur Young & Co. announce that on November 15, 1918, the following became partners in the firm: Charles Judson, Thomas H. Clarke and W. D. McGregor.

Francis Oakey announces the opening of an office at 61 Broadway under the firm name of Francis Oakey & Co.

Arthur Young & Co. announce that Frederick G. Colley has become a partner of the firm as of October 10, 1918.