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## Accounting Questions

American Institute of Accountants. Bureau of Information

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## Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

### INSTALMENT NOTES

*Question.* A corporation sells its product for a down payment and monthly notes covering from six to twenty-four payments. The corporation sells the notes to an acceptance company. The agreement with the acceptance company is in the form of a letter from the corporation, and is in part as follows:

“The notes to be endorsed by us without recourse.

“Should any debtor return any equipment, or should you deem it necessary to repossess any equipment, we will upon request, either:

A. “At our own expense, legally and physically repossess and remove such equipment from you, paying you cash therefor within sixty-one (61) days after your said request, in an amount equal to your remaining investment and all the unpaid notes relating to such equipment, with all accrued interest and charges on such instalments to the date of the payment, and will accept possession and delivery of such equipment wherever it may be and in whatever condition it may be, or

B. “At our option, we will repurchase from you all such unpaid instalments at the amount of your remaining investment therein, and accrued interest and charges thereon, and pay you therefor at your office within sixty-one (61) days after the date of your request above mentioned.”

Should any contingent liability be recorded on the balance-sheet, and if so in what form?

Is the contingent liability governed by the form of endorsement on the notes or by the agreement?

\* \* \* \* \*

Assume that the discount company's bank objects to the endorsement without recourse, and that the notes are sold with the ordinary unrestricted endorsement.

How should the contingent liability be expressed on the balance-sheet?

Is there any authority or justification for stating the contingent liability at an amount determined by taking a percentage of the total notes under discount at a given date? Said percentage is to be determined by the amount of notes

returned by the discount company compared with the total of notes sold to them, over a period of five years.

*Answer.* (1) The contingent liability should unquestionably be recorded on the balance-sheet in respect of the unpaid and unmatured instalment notes. The wording should be somewhat as follows:

**CONTINGENT LIABILITY**

In respect of unpaid and unmatured instalment notes aggregating \$ . . . . ., and accrued interest and charges thereon, subject to amount recoverable through re-possession and sale of equipment, and amount of reserve for losses through re-possession stated above at \$ . . . . .

(2) The contingent liability is governed by the terms of the agreement which annuls the effect of the restricted endorsement.

(3) In the event that the discount company's bank insists that the notes be sold with the ordinary unrestricted endorsement, the amount of the contingent liability would not be changed and it should be expressed in the same manner as indicated in the answer to question No. 1.

(4) There is no authority or justification for stating the amount of the contingent liability at an amount less than the maximum thereof.

While not stated in the question submitted, it is presumed that a reserve for losses through re-possession, based upon experience, will be set up in determining the financial position of the company. Hence, this reserve partly offsets the amount of the contingent liability and this fact has therefore been incorporated in the notation for insertion on the face of the balance-sheet outlined above in the answer to question No. 1.

*Answer.* It would seem to us that the corporation which sold its notes to the acceptance company would have a contingent liability for the entire amount of notes outstanding even though the notes were endorsed "without recourse," because of the agreement contained in the letter whereby the corporation agrees to make good any unpaid notes within sixty-one days after request by the acceptance company. The amount of the contingent liability would be based on a statement from the acceptance company as to the amount of notes outstanding and unpaid. The contingent liability, in this instance, is governed by the agreement.

Should the notes be sold with the ordinary unrestricted endorsement, the same contingent liability would exist, but, in this case, the liability would be governed both by the endorsement and by the agreement.

The contingent liability should be expressed by a footnote on the balance-sheet.

**PREMIUM BONDS**

*Question.* A corporation has sold through underwriters a mortgage bond issue of \$500,000. The indenture provides for annual retirement of \$10,000 of bonds at \$105 and creates a reserve annually to provide for the premium obligation.

The corporation has purchased in the open market \$75,000 of its bonds at \$95. To do so it has been necessary to borrow an equal amount at the bank and has pledged as security against the loan the \$75,000 of bonds in question. Barring unforeseen circumstances, the corporation has decided not to resell the bonds purchased but they must, of course, be kept alive inasmuch as they are "hocked" to secure a loan.

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Should the bonds so purchased be carried at cost or par?

In any event, isn't there an immediate realization of a five point profit on each bond and should it not be reflected in profits at the time of purchase?

Inasmuch as the bank loan is a current liability, shouldn't pledged bonds be carried as a current asset?

Until the bonds are canceled there is the legal obligation to the trustees that an adequate reserve be created annually to provide for the premium factor at date of actual redemption. This is now being done and it applies also to bonds purchased. So much of the reserve applicable to the bonds purchased is, however, ineffective and consequently sets up an over-stated liability.

What entry, if any, is required to equalize the bond premium liability that in effect is canceled when the bonds are purchased?

Bear in mind the legal necessity for carrying the reserve provisions until it has been proved to the satisfaction of the trustees that the bonds so purchased have actually been canceled.

*Answer.* If it were the intention of the corporation to resell these bonds, and if their repurchase had been actuated by the expectation of the management that the market value of these bonds would go up and allow the corporation to resell them at a profit, then the corporation should be permitted to carry these bonds as a current asset during the period that it is holding them for resale.

The foregoing statement assumes, of course, that there is an active market for the bonds. If the bonds were purchased for resale they should be carried on the balance-sheet at their cost price of \$95.

In the situation in question, however, it is stated that the bonds were not purchased for resale, but were purchased with a view to their eventual retirement. In this event, as we see it, the situation is altogether different. The corporation has incurred a current liability of \$71,250 (95% of \$75,000) and has, in effect, retired a funded obligation of \$75,000. In stating these transactions on the balance-sheet the total bonds actually outstanding should be shown and there should be deducted therefrom at their principal amount the \$75,000 of bonds repurchased for retirement.

In this event the five point discount received should be applied first of all to wiping out the unamortized discount, if any, relating to these \$75,000 of bonds in question. If the unamortized discount is in excess of the five point discount received, this difference should be written off.

### *ADVERTISING EXPENSE AND GOODWILL*

*Question.* Is it a practice among large industrial and manufacturing corporations to charge any or all of their advertising expense to goodwill? We appreciate that the advertising is commonly charged as an item of sales expense. There may be other cases, however, where the advertising is not designed primarily to affect immediate sales but rather to establish in public consciousness the remembrance of a trademark or the broad goodwill of the corporation.

Moody's *Manual* shows that several large manufacturers carry the item of goodwill in their statements. The tendency is to write this down from year to year. In the start, however, goodwill must have had a definite meaning, and some definite items and elements must have entered into it. Advertising quite likely might be one of them.

We think this is quite an interesting problem in accountancy and any information you can give us will be gladly received.

*Answer.* I have gone into this question at some length among the members of our organization and do not find that any of them have found an actual case in their experience where the amount expended for advertising was charged to goodwill.

I agree with the inquirer that his question brings up a very interesting problem in accountancy. Unquestionably in many cases advertising which is designed "to establish in public consciousness the remembrance of a trademark or the broad goodwill of the corporation" does actually create goodwill. On the other hand, there have been some cases where extensive advertising campaigns intended to create goodwill were not effective or where they have had a detrimental effect. In any event it seems to me that in no case can we say that the amount of money expended for so-called "institutional" advertising is a dependably fair measure of the goodwill created by such advertising. Since advertising may not create goodwill and since the cost of advertising is by no means a dependable measure of the value of the goodwill which may be created, it seems to me that charging such expenditures to goodwill would be an accountancy practice not to be recommended.

Aside from any strictly accounting theories on the matter, the effect of treatment of advertising expense from an income-tax viewpoint is often of great practical importance. The twelfth line of article 121 of regulations 74 mentions "advertising" as one of the business expenses which is deductible from gross income in computing net income.

In the case of *Colonial Ice Cream Company, petitioner, vs. Commissioner of Internal Revenue, respondent*, docket No. 8354, it was held in effect that there should not be allowed to the taxpayer as a deduction in 1921 a portion of advertising expense paid or incurred in 1920. Some of the reasoning in the opinion on this case is very interesting. It is admitted apparently that the benefits from the advertising campaign continued through subsequent years, but apparently the difficulty of segregating the cost of the advertising campaign as to that applicable against income for 1920 and that properly applicable against income of future years was so great that an arbitrary basis was adopted and no satisfactory proof as to the propriety of this basis was submitted.

To attempt to go into all of the income-tax phases of this question would hardly be practicable and would probably serve no useful purpose here. It seems likely, however, that concerns operating at a high enough rate of profit so that they may be known for a certainty to have a valuable goodwill, have been influenced and will be influenced, in connection with any decision as to capitalizing (under any heading) their advertising expenses, by the fact that such expenses are deductible for income-tax purposes in the year in which they are paid or incurred.

*Answer.* To the best of our knowledge, it is not the practice among large industrial and manufacturing corporations to charge any or all of their advertising expenses to goodwill. Moreover, we would not be disposed to sanction such a practice. It may be proper under certain conditions for a business to write off advertising expenditures over a period of more than one year, but it does not follow that they should be permanently or even semi-permanently capitalized.