Accounting Questions

American Institute of Accountants. Bureau of Information

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.]

NO-PAR CAPITAL STOCK ON BALANCE-SHEET

Question: A holding company having stock of no par value is formed under the laws of the state of Delaware, to acquire, and does acquire, all the outstanding capital stock of four corporations, in consideration of the issue of a certain number of shares of its own stock. As of the date of consolidation the books of the subsidiaries show a combined capital, as follows:

Capital stock	$ 600,000.00
Surplus	1,100,000.00
Total capital	$1,700,000.00

Of the total surplus shown above, $700,000 represents a capital surplus obtained by writing into the books of the subsidiaries various values for leaseholds totaling this amount.

In preparing the consolidated balance-sheet my set-up is as follows:

Capital stock:		
——— shares of no par value		$ 600,000.00
Surplus:		
Earned	$400,000.00	
Capital (leaseholds)	700,000.00	1,100,000.00

This set-up has been criticized, it being claimed that the set-up should show the capital stock at a valuation of $1,700,000, the surplus items, of course, being omitted.

Which is the correct set-up for the published balance-sheet, and how should the opening entries be placed on the holding company's books?

Answer: There is justification for the criticism regarding the second set-up to the effect that "the set-up should show the capital stock at a valuation of $1,700,000." In the case in question, the parent company is an entirely new legal entity and has acquired through purchase of stock ownership the net assets of the subsidiary companies at a given date in exchange for capital stock, its own capital stock having a value equivalent to the purchase price of $1,700,000 for assets acquired. It is obvious that the earnings of the subsidiary companies prior to date of acquisition of their stock should not be considered as earnings of the parent company.

Assuming, however, that under the Delaware law the directors adopted a resolution distributing the credit of $1,700,000 in the proportion of $1,000,000 as the stated value of no-par-value stock and $700,000 as surplus, the opening entries on the parent company's books would be:

Investment in capital stocks of subsidiary companies .... Dr.	$1,700,000	
To no-par-value capital stock, at stated value as fixed by resolution of board of directors dated ————		$1,000,000
Capital surplus, per resolution of board of directors dated ——		700,000

Answer: The holding company referred to is a new corporate entity and such a new entity can not commence business with an earned surplus. Earned surplus can arise only through actual earnings of a company subsequent to the date of its organization. Earned surpluses of companies acquired when a holding company is formed, become either capital or capital surplus. It is true that the laws of the state of Delaware are very broad in permitting the directors to determine what proportion of the total investment shall be considered capital and what proportion surplus, but the proportion designated as surplus should be termed "capital surplus" or "initial surplus" and not "earned surplus."

It is a little difficult to see why $600,000 should necessarily be set up as the value of the capital stock of the new holding company unless this amount was specifically authorized by the board of directors. The amount placed to the credit of capital of the new holding company need not have any relation to the stated capital of the four predecessor companies, although there is no objection to the same figure if the board of directors so decides.

RESERVE FOR TAX ON UNREALIZED PROFITS

Question: A corporation doing a retail instalment business pays its federal income tax on the basis of gross profit actually realized, in accordance with section 44 of the revenue act of 1928. The balance-sheet certificate is qualified as follows:

> "Subject to the contingent liability for such income tax as may be payable when profit accrued on instalment accounts receivable outstanding at ——— is realized."

Is this sufficient, or do you consider it necessary to set up an actual reserve on the basis of the estimated tax which would be payable on the unrealized profit at the present rate if the company did not take advantage of the instalment section of the revenue act?

Answer: If a corporation in the instalment business takes up all of the profit on sales on its books but prepares its tax return on the instalment basis, then in preparing a balance-sheet a reserve should be established for the estimated amount of taxes on profits taken up in the accounts but not reported for tax purposes.