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Accounting Questions

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MAINTENANCE DEPARTMENT COSTS

Question: It has been proposed that our maintenance department, the machine shop for example, should, as a practical matter, use an inventory scheme with respect to the distribution of labor. For instance, the machine shop total labor cost will be charged to a labor-process account and will represent the total hours for the department for the month. This labor-process account will be relieved by the average labor cost with respect to all the results of the department for the month. In other words, the labor will be charged to the process account at varying rates, but will come out of this account at a standard rate. Our rates for twenty-six men vary from 46 cents to 70 cents per hour, and the average is 63 cents per hour. A man under the proposed system to whom we pay 46 cents will work ten hours on a job at an actual cost of $4.60, but the standard rate will show a cost of $6.30.

This scheme does not seem to me to be theoretically correct, although I am not prepared to say just what the practical aspect of it may be.

I shall appreciate very much the opinion on this proposition of any members who may care to consider it.

Answer: For distribution of labor costs of a maintenance department, several methods are in use, the more common being either a standard rate for the department, or the individual rate of the employee engaged.

The argument in favor of individual rates is that the jobs are charged presumably according to the time and skill demanded. The arguments for the department standard rate are:

(1) Economy in bookkeeping.

(2) The assignment is not always determined according to the skill required: availability and other factors sometimes enter in.

(3) The standard rate may be in the nature of burden, including overhead expenses, as well as labor cost.

Answer: When installing cost systems, we have many times worked out a plan for maintenance department such as described in the question, as we feel that practical accuracy in distributing the charges and the saving in clerical work from using an average rate is more important than the loss of theoretical accuracy. We would, however, usually go further and work out an hourly rate including maintenance-department burden as well as labor so that the hourly charge would cover all the service of the maintenance department.

Assuming a reasonable interchange of maintenance department men in work for the various manufacturing departments, we believe that the final results, using an average rate, will be substantially correct and that in practice any theoretical inaccuracy will be more than offset by the saving of expense in keeping the records.

COST OF RESEARCH AS OPERATING EXPENSE

Question: A client for several years has pursued the policy of charging into operations all amounts spent for research, patents, etc., whether or not any benefit was derived from such expenditure. These expenditures have averaged approximately $200,000 a year for the past five years, during which the client has developed new processes and new products from which future profits will be derived. This research work is to be continued and in the course of time certain other products will be developed that will be of value. Should the cost of research be capitalized?

Answer: The practice of charging to expense all costs of current research work is not unusual; there is much to be said for it.

"If a special attempt is made to attain some definite, patentable improvement, it is permissible to carry forward the accumulating cost until results are known; if a valuable patent is secured the cost of research leading up to it may be treated as part of the patent value, and written off over either the legal life of the patent or over its estimated useful life, whichever be the shorter period.

When (as your question suggests) the company maintains, and expects always to maintain, a general research department its cost should be absorbed as general expense. If its cost were "capitalized" future years might show a great accumulation of paper assets without value, for as new processes and new products appear older ones become valueless. This is especially true of the chemical industry.

In recent years the most progressive and enlightened companies in manufacturing business have leaned strongly toward the elimination from their accounts of indeterminable, intangible values; goodwill, trademarks, patents, formulae, have been written down to a nominal sum, say one dollar.

Upon the whole I think the practice of the client in this case is admirable

RETAIL BOOKSTORES

Question: It would be a great help to us if you could get an accounting firm or firms to answer from their experience the following questions relative to accounting practice in regard to retail bookstores:

At what intervals are physical inventories of books on the shelves taken?

Are the books individually marked (coded) to show cost and selling price, or only selling price?

Are physical inventories taken at cost or selling price?

Is a running inventory kept upon the books or are purchases charged Profit and Loss and an inventory taken at the close of each period to determine the cost by setting up the new inventory?

If a running inventory is kept are sales deducted at true cost or is an estimated cost deducted, arrived at by reducing sales to a hypothetical cost by averages arrived at from a running memorandum record showing purchases at both sales price and cost, and also mark-downs (what I believe is known as the retail inventory system)?

Are shortages in inventory more or less expected and if so what percentage of cost of sales might this accepted shortage be?

What are the accepted causes of shortages?

Answer: The following is the practice of one large book store:

1. Inventories are taken on December 31.
2. Books show selling prices. Costs are obtained from sellers' catalogues.
3. Physical inventories are taken at cost.
4. Running inventory is kept of valuable books, such as books sold in sets.
5. From above sales are deducted at cost.
6. At end of year the books are costed and shortages are not known.

NOTE.—A general reserve for obsolescence of $5,000 is carried.

Answer: 1. Physical inventories are taken once a year at the end of the accounting period. If possible, a physical inventory taken twice a year is preferable. In a book store, however, the great number of separate articles makes inventorying a laborious procedure. The situation is quite different from that in many other retail sections in that each book is distinct and few copies of each are carried.

2. Books are usually marked to show selling price only, but on the more costly or "binding books" cost is shown in code.

3. Physical inventories are taken at selling price only.

4 and 5. A running inventory that is a unit control is not kept, but a retail inventory equivalent to a perpetual inventory in total at retail is kept by the statistical office of the store. This retail inventory is known as the retail inventory system and arrives at the retail inventory on hand by the following formula:

	Cost	Retail
Inventory beginning	x	x
Purchases for the period	x	x
Freight and cartage in	x	–
Additional mark-ups	–	x
Total	3	1
Less:		
Sales		x
Mark-downs		x
		2

1 minus 2=retail inventory on hand.

To this figure the difference between 100% and the gross mark-on, namely, that which 3 bears to 1, is applied to arrive at the inventory at cost.

6 and 7. Some shortages are more or less expected, but the causes are few in a book store, being confined mainly to loss from pilfering. Another cause may be the failure to make out a stub-slip for damages to a book caused either by the receiving department or by fingering by customer.

REPORTS AND WORKING PAPERS

Question: We are extremely anxious to ascertain the general procedure with respect to the following:

(a) Limitation on the right of a client to refer to the accountant's report by culling therefrom portions thereof, without submitting the entire excerpt and the explanatory language which is to accompany it to the accountant for approval.

(b) Disposition accorded the reports and working papers of old assignments. We would like to know whether the general procedure is to keep the papers on file permanently or whether any of the documents are destroyed after a certain period has elapsed.

Answer: (a) We hold that the accountant's report must be submitted in its entirety, or the portion quoted from must have the approval of the accounting firm for use separate from the main report. We feel that this is absolutely necessary, in that qualifications, if voluminous, are frequently placed in the comments rather than on the statement affected, and that, if submitted in separate statements, qualification would be necessary on the statement itself.

(b) The detailed working papers on those engagements which are continuing we keep indefinitely. On companies which are out of business or with which we have no connection, we keep the typed reports indefinitely, and the detailed working papers for six years.

On the stock-exchange questionnaires, we follow the stock exchange rule of keeping the current audit and the next previous audit.

Answer: (a) In our opinion a client has no right to refer to an accountant's report by culling therefrom portions of it without submitting the entire excerpt in so far as it refers to the matter quoted, and even in doing so the client may be reasonably expected to ask the accountant's approval before publishing or using in any way such an excerpt.

(b) It is the practice of many public accountants, in which we concur, to destroy working papers after ten years and reports after fifteen years except in unusual cases where there is a probability of such papers' being required, particularly in federal tax matters.

VALUE OF AN ACCOUNTING PRACTICE

Question: I have been established in public accounting here for about ten years during which I have established accounting relations with a certain industrial group. I am seriously considering going with this group and disposing of my public practice.

Should I do this, I would have for disposal, aside from the work which I would retain by going with this industrial group, an established and recognized office for the practice of public accounting and would turn over to the purchaser thereof a practice amounting to $11,100, expenses of $5,950, leaving a net income of $5,150. This amount could be increased without difficulty as there is no competition and the field is not exhausted.

Can you give me an idea as to the price that should be asked for this business and the basis commonly used in this profession? The office equipment amounts to about $1,000.

Answer: Replying to your inquiry concerning the sale of an accounting practice, the pertinent points seem to be (1) exactly what is for sale and (2) its value to the purchaser.

Answering these, there seems to be for sale an opportunity—perhaps of much more value to one prospective purchaser than to another. Work may be lost, held or increased by a new proprietor—depending upon his ability and personality. A purchaser with ability and success-promising personality could afford to pay more than one lacking in both qualities.

Since, then, the worth of the practice to the seller may differ from that to the purchaser the practical thing would seem to be to find an accountant desirous of buying and agree upon the value to him.

In England, we believe, there is a rather generally used basis for valuing the goodwill of our profession but we know of none here. The English situation is different because of the law.

When a manufacturing business is sold and there is no change of goods or individual contact, real goodwill passes to the new owners. In the instant case clients would receive a different service and deal with a different individual. Professional goodwill clings to its creator, can be dissociated from him only to a limited extent and at best is a fragile thing in other hands. There is a vast difference between furnishing an opportunity and delivering goodwill.

As a practical suggestion, since income is the purchaser's measure of value, should not that also measure the sale price, basing the price on one or more years' actual income to the new proprietor, he making a moderate down payment and securing the later-to-be-determined balance?

Answer: Probably a fairly standard customary practice for computing the value of an accounting practice is to use three years' earnings as a goodwill value. Of course, in every transaction of this kind, much depends on existing conditions, and whether or not those selling the practice will undertake to continue with the business in a like capacity after it has been purchased. Probably the most satisfactory basis to both the purchaser and the seller is to arrange for a percentage participation in the profits of the succeeding years rather than to base the payment on past profits.

An arrangement which has been found satisfactory is to give the seller payment for tangibles and agree to give him, say, 100 per cent. of the earnings for each of the two years following the date of the sale and 50 per cent. of the earnings of the third and fourth years.

Answer: I would not personally care to make a definite statement with regard to my idea of the value of such a practice as your correspondent outlines. Indeed, I doubt whether I would myself consider the purchase at all unless the purchase could be fortified by some assurance that the vendor could guarantee in some way that the practice would follow the sale into the hands of the purchaser. A great deal would depend upon the size of the community and the relations which the vendor had been able to establish with his clientele. The question also of the character of the practice would be important, i. e., an analysis of the fees to indicate how much was recurring and how much non-recurring.

The better plan for a purchaser would, I think, be to establish some relationship under which he would give a commission to the vendor based on the actual fees received out of a certain designated list of clients, such commission being restricted to, say, from 15% to 20% of gross fees, at the outside, and for a limited period only, say three years. An arrangement of this kind would neither be unreasonable on the part of the vendor nor unfair to the purchaser, but any other arrangement might prove unsatisfactory.

Answer: It seems to me that this is peculiarly a question which can only be settled satisfactorily by applying the law of supply and demand.

The practice on question is worth what someone is willing to pay for it. The writer indicates that he has a practice to sell which would realize after all expenses, a net annual income of $5,150, and further, that this income could be increased without difficulty because of the lack of competition and the possibilities of the field. The seller could not, of course, hope to obtain anything for the undeveloped practice, and it is not clear whether or not any deduction has been made for the service of the principal in arriving at the hypothetical net income of $5,510. If there is no such deduction then the latter amount would have to be considered in relation to the market value of the services of the man buying the practice. If his services were worth $5,000 a year, and he had to give his entire time to earning the net income indicated, it is apparent that he would not expect to pay very much for the goodwill of the old practice. At any rate in such a case there would be no basis in the figures submitted for determining a fair price.

On the other hand if it be assumed that the expense mentioned included compensation for the principal, I believe that the seller might justly ask for a sum representing twice the net income plus the value of the office equipment. The whole question, however, is so subject to local conditions and to local ideas as to value that it is impossible to give a firm opinion.