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Accounting Questions: Manufacturing Companies and Sales Subsidiaries, Auditor's Certificates

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Accounting Questions

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MANUFACTURING COMPANIES AND SALES SUBSIDIARIES

Question: A corporation, engaged in manufacturing a commodity, owns the entire capital stock of a subsidiary whose functions are confined to selling the manufactured product. The manufacturing corporation has shown substantial earnings each year but such earnings have fluctuated considerably, due principally to changes in the value of raw materials. It is the desire of the management to insure a fair profit to the sales corporation so that the true manufacturing profit will be reflected in the accounts of the producing corporation and the selling profit in the accounts of the sales corporation. During the past three years an attempt has been made to fix the price to the sales corporation at the beginning of each year with the above end in view, but in the three past years the sales corporation has shown a substantial profit in one year, a substantial loss in another, and has about broken even in the third. It would appear that the most logical way of bringing about the desired result would be for the manufacturing corporation to sell its product to the sales corporation on a cost-plus basis, the percentage to be fixed by past experience.

Will you please ascertain, if possible, whether or not such a method has been generally adopted by organizations similarly situated and also what other methods have been found practical in actual use?

Answer: The writers have knowledge of several plans carried out successfully where similar relationships exist and where in each instance the parent and/or manufacturing company were desirous of supplying their products to the selling companies at sufficiently attractive prices so as to permit the latter to earn a fair margin of profit after deducting all expenses without at the same time unduly burdening their own operations.

Plan 1

The manufacturing company agrees over a specified period to supply its sales subsidiary with products on the basis of predetermined prices, subject to revision quarterly or semi-annually, to net the manufacturer full cost of material, labor, factory overhead, plus a small percentage, usually not over 10% nor less than 5%, on the total factory cost, to cover a fair portion of the manufacturer's supervision or administrative cost and a small margin of profit.

The manufacturer in determining prices to the selling company provides that such prices are subject to revision quarterly or semi-annually, depending on the trade practice followed by the industry with respect to price revisions. When the manufacturer calculates his material costs they should not vary much from current prices, and if the supply on hand is inadequate to meet the selling company's needs he usually covers his requirements at definite prices to guard against a rising market in the raw materials involved.

If the manufacturing company carries diversified products, differentials are allowed between certain classes or types of product to stimulate sales in the most profitable direction.

Plan 2

The manufacturing company agrees for a specified period to supply the sales subsidiary with products on the basis of full factory cost and to divide the net profits of the latter in the proportions of 50% to the manufacturer and 50% to the seller. The manufacturer requires this 50% share in consideration of his supervision, financial assistance and other valuable service conducive to a successful sales programme.

Plan 3

Where the manufacturing company itself is also engaged in selling its products to the trade, in a territory not reached by the subsidiary, it agrees for a specified period to supply products to the latter at its own regular sales prices less its own regular percentage of selling expense and less half of its own usual margin of profit.

All three plans operate more or less satisfactorily, but the first two enumerated give the best results.

When these plans fail, the difficulty can usually be traced to the manufacturer for having endeavored in a period of violent price fluctuations in raw materials to penalize the selling company for mistakes of the manufacturer in purchasing its materials. The selling company should always be placed in a competitive position by being able to secure its needs on the bases of current or nearly current market levels. The failure to observe this rule imposes an unfair hardship on the selling organization, and it involves the loss of prestige or goodwill of its customers. It is recognized in almost every industry that when raw-material prices decline the prices of the finished products in which they are used also decline, and however competent a sales organization may be it can not combat the demands of the trade for lower prices. The manufacturer is compelled to face this inevitable procedure, and must be prepared to accept losses due to his own bad judgment in buying or due to other economic causes beyond his or the seller's control.

Answer: While we have seen an attempt made to reach the desired result by a manufacturing corporation selling its product to a sales corporation on a cost-plus basis, the percentage being fixed by past experience, it has been found that this does not always work out satisfactorily for obvious reasons. An alternative method, however, which we have seen in operation satisfactorily is for the manufacturing corporation to charge the selling corporation at a discount from the selling corporation's normal average selling price, such discount being sufficient to cover the normal overhead of the selling corporation and to leave a normal profit. There are many considerations that enter into an arrangement of this kind and should it not be found possible for the manufacturing corporation to make a profit as well as the selling corporation under such an arrangement, it is obvious that the manufacturing corporation's costs are too high from inefficient management, lack of facilities, improper location, lack of capital or other reasons. It is, of course, presumed that the utmost good faith exists between the management of the manufacturing corporation and the management of the selling corporation and that the management of the selling corporation is efficient and able to obtain the best prices consistent with the market and other surrounding conditions.

AUDITORS' CERTIFICATES

Question: I have before me the annual report of . . . company and contained therein is the audit certificate, signed by a large and well known firm, which refers to the books of the subsidiary companies and says in part "As a result of our examinations we found the accounts to be well and accurately kept."

The 1928 annual report of the . . . company contains the following certificate of another prominent firm:

"We have audited the accounts of the . . . company for the year ended December 31, 1928, and have been furnished with balance-sheets and income accounts of its subsidiary companies, whose accounts we have not audited, and certify that the accompanying condensed consolidated balance-sheet as at December 31, 1928, and condensed consolidated income account for the year ended that date are in accord therewith."

"A" contends that both certificates are clear and unqualified while "B" maintains that they are both full of qualifications and, while the statements may be in accord with the books, not one word is said as to the correctness of the accounts.

Answer: The excerpt from the accountant's certificate appears to be a clear statement of facts, not of itself expressing anything of the nature of a qualification. Apparently the auditor found that the accounts of the subsidiary companies were accurate, that he verified that fact and he says so. Nothing could be more unqualified.

With respect to the certificate said to be embraced in the annual report of the . . . company for 1928, note particularly the last two phrases of said certificate, "and certify that," . . . "are in accord therewith." The word "therewith" relates directly to unaudited statements and therefore the accountant in that certificate merely certifies that the statements he presents are in accord with other statements only. He does not say he has verified nor does he so certify the state of facts disclosed on the face of the accounts. Therefore, this certificate appended to consolidated statements of parent and subsidiary companies for that reason is on its face qualified. No argument is needed as to that. The auditor says he has not audited sub-company accounts —that is clear warning to the reader of the statement.

The subject of qualification in an accountants' certification is always a serious matter with him. It must necessarily be one of judgment, but it is not hard to discriminate and to see wherein the auditor has qualified his statement.

A balance-sheet with an auditors' certificate upon it introduced by the words "we have audited and we certify," together with an expression of opinion as to the correctness, represents to others that he has made a verification, more or less complete. If there are items as to which the verifications are incomplete or unsatisfactory he is in duty bound to say so in a manner qualifying or limiting his certificate.

Answer: In answering this question, it is our opinion that the terms used would mean that in form, penmanship, and mathematical accuracy, the books of account were "well and accurately kept."

Nothing is said about whether or not it is a fact "that as a result of our examination the accompanying balance-sheet and profit-and-loss account, in our opinion, correctly state the financial position of the company at the date indicated, and the result of its operations for the stated period, subject to the balance-sheet and income statements of the subsidiary companies furnished to us but whose books and accounts we have not audited."

In the second case, you say the report certifies—"We have audited the accounts of the . . . company for the year ended December 31, 1928, and have been furnished with balance-sheets and income accounts of its subsidiary companies, whose accounts we have not audited, and certify that the accompanying condensed consolidated balance-sheet as at December 31, 1928, and condensed consolidated income account for the year ended that date are in accord therewith."

Our answer to this question is that the certificate appears to avoid a direct declaration such as stating "that as a result of our audit the statements submitted accurately state the financial position of the company," with the qualification "that we have not audited the books and accounts of the subsidiary companies, but have accepted the figures of these companies furnished to us and have consolidated them with the figures of the parent company which we have audited and found correct."

The certificates above quoted by the questioner may not necessarily be "full of qualifications"; but we prefer certificates which are more positive and direct and contain the necessary qualifications as positive statements.