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Accounting Questions

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ACCOUNTING FOR HOLDING COMPANIES

Question: A holding company "X" owns several subsidiaries through stock interests. These subsidiaries we designate as "A," "B" and "C." The capitalization and ownership of these companies is set forth in the following schedule:

	Cumulative 7% first preferred shares	Cumulative 6% second preferred shares	No-par common
Company A:			
X ownership	1,000		95%
Minority interest		500	5%
Company B:			
X ownership	900		95%
Minority interest	100	500	5%
Company C:			
X ownership	1,000		95%
Minority interest		500	5%

The following tabulation shows the surplus and undivided profits account at the beginning of the accounting period and the result of operations for the year.

	Surplus or deficit beginning	Profit or loss
Company A	$25,000	$ 9,000
Company B	5,000	12,000
Company C	10,000	18,000

The paid-in or stated value of company C's common stock is $25,000.

The schedule below gives the status of the companies in respect to dividends at the beginning of the accounting period and payments throughout the year:

	First preferred		Second preferred	
Company A:				
In arrears........		None		None
Payments........	1 yr.	$7,000	1 yr.	$3,000
Company B:				
In arrears........	1 yr.	7,000	1 yr.	3,000
Payments........	½ yr.	3,500	½ yr.	1,500
Company C:				
In arrears........	1 yr.	7,000	1½ yr.	4,500
Payments........		None		None

The questions are:

(a) What portion of the beginning surplus should be taken in to X company from each subsidiary, and what portion credited to the minority?

(b) What are the current earnings from each company to be taken into the profit-and-loss account of company X, and what portion accrues to the minority?

(c) How to prepare a statement of consolidated surplus at end of current period, with surplus account, reconciling the earnings to beginning surplus and minority balances for each company and also specifically the treatment of the $3,000, by which the deficit at end of period exceeds the common-stock equity.

Answer: This question appears to relate to the accounts of a holding company which carries on its books its share of the net worths of subsidiaries as reflected in the accounts of the latter, and the question of principle involved appears to be: To what extent should dividends in arrears on cumulative preferred stock of a subsidiary be recognized in determining the portion of the surplus or deficit of such subsidiary to be taken up by the holding company?

We think that in allocating earned surplus full recognition should be given to cumulative dividends in arrears, since the status in respect of such dividends would be an essential factor in determining any actual distributions of surplus.

On this basis, we have made the following computations:

(a) *Allocation of beginning surplus:*

	Company		
	A	B	C
Company X share..........................	$23,750	$4,500	$ 9,500
Minority share............................	1,250	500	500
	$25,000	$5,000	$10,000

Explanation:

Company A: Surplus allocated according to common-stock holdings, there being no arrearage of preferred dividends.

Company B: Surplus allocated according to 1st preferred-stock holdings, the first-preferred dividends in arrears being in excess of the surplus.

Company C: Deficit allocated according to common-stock holdings, the common stock being in excess of the deficit.

(b) *Allocation of current earnings:*

	Company A	Company B	Company C
Company X share as to:			
Common stock	$ 950	$	$14,250
1st preferred stock	7,000	8,100	
2nd preferred stock			
Total	$6,050	$ 8,100	$14,250
Minority share as to:			
Common stock	$ 50	$	$ 750
1st preferred stock		900	
2nd preferred stock	3,000	3,000	3,000
Total	$2,950	$ 3,900	$ 3,750
Total current earnings	$9,000	$12,000	$18,000

Explanation:

Company A: Preferred dividend requirements having exceeded earnings by $1,000, a loss of this amount appears in reduction of the beginning of year surplus allocated to common stock.

Company B: Earnings apportioned first to meet dividend requirements of first-preferred stock in full, balance being allocated to second-preferred stock.

Company C: Loss charged against common stock to a point at which the deficit equals the paid-in or stated value of that stock, the remaining $3,000 loss being charged against second-preferred stock.

(c) *Allocation of surplus for year:*

	Company A	Company B	Company C
Company X share:			
Balance at beginning of year	$23,750	$ 4,500	$ 9,500
Current earnings	6,050	8,100	14,250
	$29,800	$12,600	$23,750
Less dividends paid	7,000	3,150	
Balance at end of year	$22,800	$ 9,450	$23,750
Minority share:			
Balance at beginning of year	$ 1,250	$ 500	$ 500
Current earnings	2,950	3,900	3,750
	$ 4,200	$ 4,400	$ 4,250
Less dividends paid	3,000	1,850	
Balance at end of year	$ 1,200	$ 2,550	$ 4,250
Total at end of year	$24,000	$12,000	$28,000

The above treatment results in allocation of the end-of-year surplus on the following bases:

Company A: Surplus allocated according to common-stock holdings, there being no arrearage of preferred dividends.

Company B: Surplus allocated according to first-preferred stock holdings to the extent of the $10,500 first preferred dividends in arrears; remaining $1,500 allocated to second-preferred stock, as applying against the $4,500 second-preferred dividends in arrears.

Company C: Deficit allocated according to common-stock holdings to extent of the $25,000 paid-in or stated value of the common stock, the remaining $3,000 deficit being charged against second-preferred stock.

As before stated, the foregoing computations are based upon full recognition of cumulative preferred dividend arrearages in allocating surpluses of subsidiaries, but these arrearages are not recognized to a point at which they would impair the paid-in capital represented by stocks of subordinate issues—that is, the dividends in arrears are considered only to the extent to which there are surpluses to cover them.

In treating the matter in this manner, we have proceeded upon the assumption that the subsidiaries are all to be considered on a going-concern basis. If a company without surplus enough to cover its cumulative dividends were on the point of dissolution, a question might arise as to whether these dividends should or should not operate to increase the equity of a preferred stock even to the impairment of the paid-in capital represented by subordinate issues.

Even on the going-concern basis, the dividend arrearages in excess of surplus would have their bearing in determining the distribution of profits subsequently to be earned and would thus constitute one element in valuing the several issues, if a revaluation in the holding company's accounts were contemplated. In the absence, however, of any general question as to revaluation, consideration has not been given in our computations to this phase of the matter.

It is noted that company B paid a dividend of $1,500 on its second-preferred stock while first-preferred dividends were still in arrears; the allocation of company B's surplus at the end of the year is, therefore, different from what it would have been if dividend distributions had been properly made.

FINANCIAL STATEMENT OF A CHURCH

Question: An institution receives its income principally from membership dues, rental of pews and donations. In 1926 a special appeal was made to the membership to raise funds for the purpose of reducing the mortgage on its building. Pledges aggregating $23,650 were made. The stipulated terms of payment were as follows: $100 pledges were to be paid within six months of the appeal, $250 pledges within one year, $500 pledges within two years, and pledges of $1,000 or more within four years. Twenty-five per cent of each pledge was to be paid within thirty days of the appeal, and the balance in equal quarterly instalments within the time allotted above. Of the total amount of $23,650 pledged in 1926, approximately $5,000 had been paid prior to December 31, 1930.

The entry on the books to record these pledges was:

Mortgage fund pledges receivable	$23,650	
Surplus		$23,650

Consequently subsequent balance-sheets carried the unpaid pledges as an asset with a corresponding increase in net worth.

In discussing this matter with the officers I stated that it was my opinion that the net worth of the institution was overstated to the extent of the unpaid pledges and that these pledges were improperly treated as an asset. I contended that information relative to this item should be portrayed thus on the balance-sheet:

Assets		
Mortgage-fund pledges receivable	$18,650	
Less unpaid pledges	18,650	$ 0

I believe that the following entries should have been made properly to record the various transactions:

1. To record the pledges originally made in response to the appeal:

Mortgage-fund pledges receivable	$23,650	
Unpaid mortgage-fund pledges		$23,650

This is intended to be a memorandum entry. For balance-sheet purposes the latter account should be treated as a valuation reserve and deducted from the former, as shown above.

2. To record the payment of pledges:

Cash	$ 5,000	
Mortgage-fund pledges receivable		$ 5,000

At the same time to recognize the creation of a liability in the form of a trust and to reduce the amount of unpaid pledges, the following entry should also be made:

Unpaid mortgage-fund pledges	$ 5,000	
Trust, mortgage fund		$ 5,000

3. To record the transfer of the funds to the trustee:

Trustee, mortgage-fund cash	$ 5,000	
Cash		$ 5,000

4. To record the payment by the trustee in reduction of the mortgage:

Mortgage payable	$ 5,000	
Trustee, mortgage-fund cash		$ 5,000

Also, to show the resultant increase in the net worth and the simultaneous discharge of the trust obligation, this entry should be made:

Trust, mortgage fund	$ 5,000	
Surplus		$ 5,000

The net result of the above entries would be this:

Mortgage-fund pledges receivable	Dr.	$18,650
Unpaid mortgage-fund pledges	Cr.	$18,650
Mortgage payable	Dr.	$ 5,000
Surplus	Cr.	$ 5,000

The next problem with which I am confronted in this matter is this: The members are to be furnished with a condensed balance-sheet and income statement which are to be made a part of the annual report submitted by the officers.

The president has requested that a short form of certificate of audit be appended. The officers and directors, however, are to receive a detailed audit report which will contain lengthy comments and qualifications regarding such matters as the improper mingling of funds, the overstatement of members' accounts receivable, the loose methods followed in the accounts and records, and perhaps other comments. The question is: Must these comments and qualifications be stated in the certificate accompanying the members' report, or is it sufficient if such certificate read: "Subject to the comments and qualifications contained in my report to the officers and directors of . . . date, I hereby certify, etc. . . ."?

The officers and directors feel that a certificate stating all the comments and qualifications would have a very unfavorable effect and no doubt unjustifiably cause the resignation of some members. The present administration of the institution does not seem to be responsible for the existing conditions; nevertheless there may be members who might rashly conclude that they are, without taking the trouble to discuss the matter. Furthermore, the officers contend that those members who have sufficient interest in the affairs of the organization to seek further information may ask to see the detailed audit report and at such a time satisfactory explanations will be forthcoming.

Answer: It would no doubt be the most conservative practice to show mortgage-fund pledges receivable in the amount of unpaid pledges with a deduction for the amount of unpaid pledges, leaving no balance carried as an asset. On the other hand, if the pledges are from responsible people and are probably collectible, then there seems to be no particular objection to showing the estimated collectible amount as an asset with proper description as to the dates when payments thereon are due.

It hardly seems necessary that detailed comments with regard to the audit should be included in the certificate, provided the statements are prepared to present correctly the financial position and operations. Even though there has been improper mingling of funds, the funds should be correctly stated in the statements. Although there has been overstatement of members' accounts receivable, these accounts should be correctly stated by the accountant. In other words, the accountant should be able to prepare the financial statements in a proper manner or else he should not attempt to certify them at all. On the other hand, if there is some qualification necessary because it is impossible definitely to ascertain some fact, and such a condition does not grossly distort the financial statements, or if there is some reasonable difference of opinion, then a qualification should be inserted in the certificate.