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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.]

SALES OF INVENTORY TO AFFILIATED COMPANY

Question: An auditor (A) has been doing the work of a manufacturing company (X) for a number of years. This manufacturing company is affiliated with a processing company (P) which the auditor does not examine. At the close of 1930, X company had a large inventory of its main raw material and, being desirous of reducing this, sold a substantial amount (practically one-third of its entire inventory) to P company. Company P borrowed money on warehouse receipts on this merchandise and paid company X in cash in full. Company X thereupon paid off a large amount of current indebtedness, which, of course, had the effect of improving its current ratio.

In 1931 company X will gradually repurchase from P, either in processed state or original raw state the raw materials sold by it at the end of 1930 to company P.

Company X having sold the raw materials to company P at cost, insists that no mention of this transaction be made by the auditor in his report. The auditor, on the other hand, feels that since this was not a transaction in the ordinary course of business, since it involved a relatively large percentage of the inventory and was consummated at the end of the year with an affiliated company, some mention should be made of it in his report. In your opinion, what position should the auditor take, and how emphatic should he be if not in agreement with the client.

Answer: It seems to us that the question turns to a considerable degree upon what is meant by an affiliated company. If the affiliated company is a controlled or substantially owned company, then we think that the auditor in his report should mention the transaction. On the other hand, if the affiliated company is independently owned by the same interests and there is no onerous obligation on Company X, then on the statement of facts in your letter we do not think the auditor could insist on making mention of the transaction in his certificate.

The question is one of so-called "window dressing," which always gives rise to some of the most difficult situations with which an auditor has to deal. In

certain cases where a company resorts continuously to such practices the auditor's only remedy is to decline the audit on the ground that it is a bad moral hazard. This particular transaction was apparently fully disclosed to the auditor, but it is quite possible that information regarding similar transactions might be withheld from him.

Answer: From the facts, as stated by the correspondent, we are disposed to think that he need not be insistent upon stating all the facts regarding the transaction in his report. We are influenced in this decision largely by the statement that company X will *gradually* repurchase the stock from company P; that is to say, the transaction was not obviously a window-dressing subterfuge which was reversed at the beginning of the succeeding period. Further it is difficult to see that the transaction was prejudicial to the interests of the stockholders or the creditors of company X.

Answer: This is one of many cases which come close to the border line and in respect of which one should have considerably more information than that presented in the inquiry.

Generally speaking, if either a written or oral agreement exists between the respective companies regarding the repurchase of material, or if previous practice or admission on the part of either indicates that such will be the case, the transaction must be disclosed by a qualification in the auditor's certificate. On the other hand, one may well suppose cases in which a change in the policy of a company might justify the disposition of a substantial portion of inventory, at costs, and if it were clearly demonstrated that the transaction did relate to such a change in policy no such disclosure would be necessary. Obviously such a change in policy could not contemplate a repurchase of such material in the ensuing period.

When it is stated that the companies are affiliated we assume that neither is a subsidiary of the other, but rather that both are controlled by the same interests. The question of inter-company relationships between parent and subsidiary therefore does not enter into the case.

The auditor in this case seems to have made up his mind that the materials in question will be repurchased in the ensuing period, and in the circumstances it is incumbent upon him to insist upon reference to such repurchase arrangement in his certificate.

ACCOUNTANCY PRACTICE

Question: What should be paid for the accountancy practice of a deceased associate under the following conditions;

Income: Gross fees to the decedent have averaged about \$4,000.00 for the past three years.

Gross fee for work handled through the office of the buyer and controlled by the decedent have averaged about \$1,000.00 to \$1,500.00 a year for the same period. The fact of contact and knowledge of the audits being had by the buyer has retained one of these accounts of about \$1,100.00 a year.

Portion of practice of decedent was turned over to a local practitioner near the home of the decedent by the widow, amounting to \$500.00 to \$1,000.00. The terms made with this man we do not know.

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Balance of practice which may or may not be retained by the buyer longer than the current year will amount to from \$1,000.00 to \$1,500.00. These accounts are among many clients some of which require a day or part of a day a month, and some of which require only a day or two annually or semi-annually, and the individual fees range from \$50.00 to \$300.00 a year.

Buyer was a personal friend of the decedent, no partnership having ever been arranged because of the relative small amount of his practice as compared with that of buyer.

Widow naturally seeks as large a return as possible, and because of her lack of knowledge of accountancy practice and its difficulties feels that a personal arrangement made by a friend will be to her detriment.

The buyer followed up many of the small clients in order to save some of the practice and if this had not been done, the work would all have been scattered among various small practitioners of lesser standing, to whom the small clients would have been more valuable.

Answer: As a preliminary, may I point out that no information is given regarding the amount of the net profit yielded by the accountancy practice to which reference is made, and, secondly, that the volume of business is so small that its purchase would be unattractive except to a rather limited circle of possible buyers. The purchase of an accountancy practice, as of any business, is usually determined by the amount of annual profits that may reasonably be expected in the future, and the general attractiveness of the practice would have some influence on the price which a willing buyer would pay.

In the absence of further information regarding the practice to be sold, I am inclined to suggest that the fairest method, both to the buyer and to the seller, would be for the buyer to undertake to pay to the seller a percentage upon each gross fee for each of a period of years. It would seem to me that the percentage might range anywhere from ten to twenty per cent. upon each fee, and the period of time over which these amounts would be payable might range from five to ten years. Naturally, if the percentage agreed upon should approach the higher limit just mentioned, the period of years would tend to be reduced.

As a starting point for discussion it would, perhaps, be reasonably fair for the buyer to pay an amount equal to one year's gross fee for work of a continuing character. It must be borne in mind, however, that such a rule can be accepted only as a very general one and that in individual instances the profitableness of the work might make such a price inadequate from the standpoint of the seller. Similarly, if the margin of profit in another instance is unusually small, the purchaser might not be justified in paying as much as one year's gross fee. Of course, for work that is of an intermittent type or may disappear altogether within a short time, the value would be substantially less than for sound permanent connections.

As I have already intimated, it would be impracticable, without further information, to give an opinion with any degree of definiteness upon the value of the practice to which reference is made, but the foregoing suggestions will, perhaps, indicate a line of procedure upon which the buyer and seller in this case may reach an agreement.